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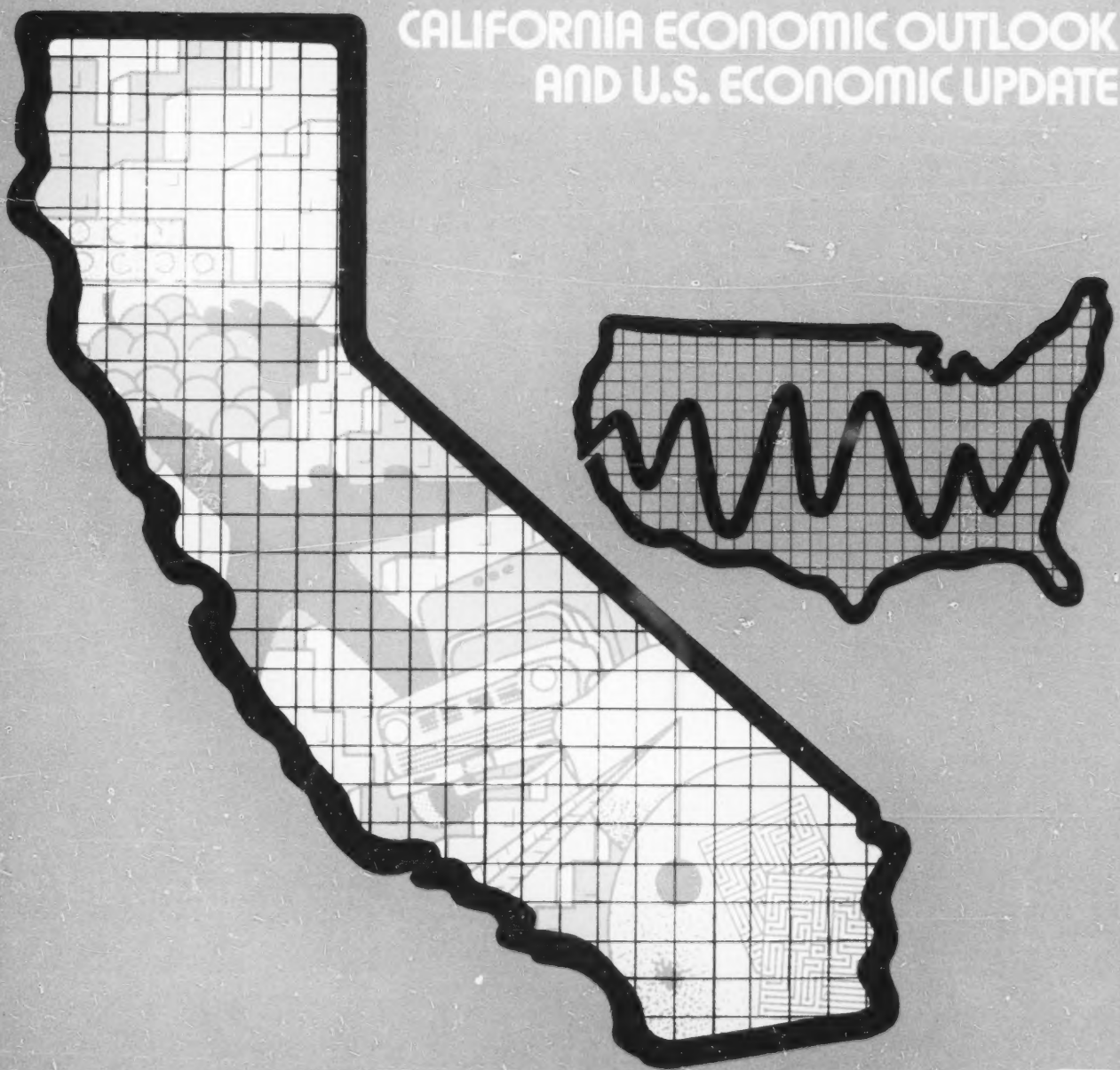
ECONOMIC REPORT

FALL 1985

CALIFORNIA ECONOMIC OUTLOOK AND U.S. ECONOMIC UPDATE



SECURITY PACIFIC NATIONAL BANK

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This report highlights the near-term outlook for the California economy through 1986, and includes a near-term update of the U.S. economy.

The ECONOMIC REPORT may be received on a regular basis upon request to:

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THE CALIFORNIA NEAR-TERM OUTLOOK

OVERVIEW

Now well into its third year of the current economic expansion, California has exhibited strong-to-moderate growth since the severe recession of 1981-82. California is coming off a year (1984) which saw it grow at the phenomenal inflation adjusted rate of 8.4 percent. This large gain in state output followed an increase of 4.6 percent in 1983, after a decline of 2.2 percent in 1982. The creation of jobs, along with the resulting gains in personal income and consumer spending, was the main impetus to the state's high rate of economic growth in 1984. California is expected to grow at a moderate pace — 3.7 percent in 1985, and 4.2 percent in 1986. Economic growth will be slower but more sustainable.

California's banner year in 1984 was virtually shared by all sectors of the state's economy. Possibly the strongest sector last year was housing, with residential building permits up almost 30 percent over 1983. In all, 218,000 residential permits were issued in 1984, the state's highest total in permits this decade. This total is even more remarkable when it is recalled that residential building permits just two years ago had reached rock bottom at 84,000 permits. From 1982 to 1984, residential permits in California had increased an astonishing 160 percent. Housing will continue to be a mainstay in California's economy over the course of the next two years. Because of favorable mortgage interest rates, residential building permit activity in 1985 will rise 10 percent to 240,000 units. With mortgage rates beginning a gradual ascent by 1986, residential building permits will taper off to 220,000 units, a decline of 8.3 percent.

GROSS STATE PRODUCT AND PERSONAL INCOME

(Billions of Dollars)
(Quarterly Detail, 1985-1986)

	1985F				1986F			
	I	II	III	IV	I	II	III	IV
Gross State Product	475.6	485.6	495.5	504.3	513.5	522.3	531.7	542.8
1972 Dollars	201.8	204.8	207.6	209.6	211.7	213.5	215.4	217.8
Personal Income	392.0	400.9	408.8	416.6	424.9	432.9	441.1	449.8
Disposal Personal Income	334.2	342.5	348.9	355.3	363.4	369.1	376.0	383.2
1972 Dollars	144.6	147.1	148.6	150.0	152.0	152.9	154.2	155.6
Annual Rates of Change:								
Gross State Product	0.6	9.0	8.5	7.3	7.5	7.0	7.4	8.6
1972 Dollars	–4.5	6.1	5.7	3.8	4.1	3.4	3.7	4.5
Personal Income	1.2	9.4	8.1	7.8	8.2	7.8	7.8	8.0
Disposal Personal Income	–1.8	10.3	7.7	7.5	9.4	6.4	7.7	7.9
1972 Dollars	–4.9	7.0	4.3	3.7	5.5	2.4	3.4	3.6

A = Actual F = Forecast

1984's strong economic expansion also benefited state employment greatly. Nonagricultural wage and salary employment increased by 610,000 or 6.1 percent, the state's best performance since 1978 — easily surpassing the nation's employment growth of 4.5 percent. In addition, California's strong employment growth occurred in all but the government sector, reflecting employers seeking to fill expanding product and service demands. In 1982, the last year of the recession, the unemployment rate for the state stood at 9.9 percent. Since then the unemployment rate has fallen sharply, from 9.7 percent in 1983 to 7.8 percent in 1984. Nonagricultural employment will grow by 4.2 percent in 1985, adding over 440,000 new jobs to the state. However, employment growth will taper off considerably in 1986, expanding by only 2.5 percent or about 276,000 new jobs. The unemployment rate, therefore, will drop down from 7.8 percent in 1984 to around 7.6 percent in 1985. Unfortunately, the unemployment rate will begin to rise in 1986, to 7.8 percent. Nevertheless, jobs will be created through the end of 1986.

Personal income in 1984 grew at the exceptionally strong pace of 11.2 percent. Fueling last year's tremendous burst in personal income was the strength of the economic recovery resulting in large employment gains. With a 10.1 percent gain in per capita income in 1984, California placed among the top five states in the U.S. on a per capita basis. California's per capita income was $14,482 as of the end of 1984. Total personal income in California will increase a moderate 7.9 percent in 1985, followed by another moderate 8.1 percent increase in 1986, outpacing the growth in personal income for the nation in both years. The precipitous drop in inflation over the past several years has allowed real disposable personal income to grow faster than it might have otherwise. The additional income was to a large extent responsible for the healthy gains witnessed in retail sales. Real disposable income gains in 1985-86 will be on the order of four percent each year. Last year's modest advance in consumer prices (5 percent) was surprising, considering the strength of the economic expansion. Normally, a sharp upswing in real output is accompanied by an acceleration in prices.

Inflation in California is expected to remain contained, rising 4.5 percent in both 1985 and 1986. Taxable retail sales, a proxy for consumer spending, was up a buoyant 14.5 percent in 1984. Retail sales' strong showing was led by a rebound in car sales, and the continued strength of housing. Consumer confidence, a bit shaky in the first half of 1985, appears to be firming up as we move through the second half of 1985, regaining some of its earlier momentum. Taxable retail sales will grow by 9.6 percent in 1985, tapering off slightly to 8.5 percent in 1986.

In spite of a slowing economy, California's economic performance will continue to be sound. The state's economy is still creating jobs, and the economic outlook for the nation is expected to improve. The economy now seems to be in a holding pattern, moving neither up nor down, but drifting sideways. We are cautiously optimistic that the economy has seen the worst of the slowdown this year, and feel that it will begin to pick up in late 1985 or early 1986. In the interim, the economy will continue on its sluggish growth path, then gradually reaccelerate in 1986. California's economic growth in 1985-86 will be much slower than in 1984.

EMPLOYMENT

Perhaps no area better exemplifies how strong the economic expansion was in 1984 than the growth in state employment. Nonagricultural wage and salary employment increased by 610,000 or 6.1 percent. Last year's gain in employment was the state's best since 1978, easily surpassing the nation's employment growth of 4.5 percent. In fact, 15 percent of all nonagricultural wage and salary jobs added in the United States last year were created in California. When broken down into categories, California's strong employment growth in 1984 occurred in all but the government sector, reflecting employers seeking to fill expanding product and service demands.

In 1982, the last year of the recession, over 1.2 million Californians were unemployed and the unemployment rate stood at 9.9 percent. Since then, the number of unemployed has dropped to under a million, and the unemployment rate has fallen dramatically, from 9.7 percent in 1983 to 7.8 percent in 1984. By the end of that year, over eleven and a half million Californians were working.

Nonagricultural employment will grow at 4.2 percent in 1985, adding over 440,000 new jobs to the state total. However, employment growth will taper off considerably in 1986, expanding by ony 2.5 percent or about 276,000 new jobs. Similarly, total civilian employment will also grow by 4.2 percent in 1985, with a projected employment increase of 484,000. In 1986, total civilian employment will increase by 2.4 percent or 289,000. The unemployment rate will fall from 7.8 percent in 1984 to around 7.6 percent in 1985. However, both the number of unemployed and the unemployment rate will rise again in 1986, to over one million and 7.8 percent, respectively. The unrelenting growth in the state's labor force will continue to put pressure on the need for new

jobs, but the economy will not be able to generate jobs fast enough to match the number of new entrants into the labor force. Nevertheless, jobs will be created throughout the forecast period.

Service and trade employment led the way in 1984. Service employment grew by 8.2 percent, adding 191,400 jobs, followed closely by wholesale and retail trade employment which grew 7.2 percent, adding 168,700 more jobs. These two sectors alone accounted for 59 percent of all the job growth in the state last year, illustrating the continuing shift from the goods producing sectors toward the services and service related sectors. Both sectors clearly responded favorably to declining interest rates, brisk consumer spending, and the resurgence in business investment. Particularly prominent was the job growth in business services, which was up a spectacular 18 percent, accounting for nearly half of all service employment growth in 1984. Trade and service employment growth will be moderating in 1985 and 1986 in step with a slowing economy in both years.

While the service and trade sectors had the largest numerical growth in employment, the construction industry registered the largest percentage growth with a scintillating 20.6 percent increase. This is not surprising in view of the tremendous strides the housing industry has made since 1982 when residential building permits were well under 100,000 units. In 1984 however, permits reached 218 thousands, and should surpass that figure in 1985 and possibly 1986. Consumers' pent-up demands and the lowest mortgage interest rates in five years are credited with triggering the strongest housing activity since 1977. But the fast leap in construction employment was not solely due to the strength in housing demand. Exceptionally strong growth in nonresidential construction over the past several years has also been a boon to construction employment. There was also a large increase in transportation-related construction contracts awarded last year. While homebuilding will be strong in 1985 and 1986, and highway contracts are expected to continue increasing, relatively high vacancy rates in commercial and industrial space are expected to cool off the current pace in

CALIFORNIA EMPLOYMENT, 1984-1986

(Thousands)

				Annual Rates of Change		
	1984A	1985F	1986F	1983-84	1984-85	1985-86
Civilian Labor Force	12,502	13,002	13,340	1.9	4.0	2.6
Total Civilian Employment	11,530	12,014	12,303	4.0	4.2	2.4
Unemployment	972	988	1,037	-18.0	1.7	5.0
As % of Labor Force	7.8	7.6	7.8	—	—	—
Nonagricultural Wage & Salary Employment	10,576	11,020	11,296	6.1	4.2	2.5
Mining	50	56	58	4.0	11.1	4.0
Construction	445	477	519	20.6	7.1	9.0
Manufacturing	2,055	2,084	2,150	6.1	1.4	3.2
Nondurable Goods	645	657	684	3.8	1.8	4.2
Durable Goods	1,410	1,426	1,464	7.2	1.1	2.7
Aerospace	714	739	762	7.9	3.5	3.1
Transportation & Utilities	554	570	581	3.3	2.9	2.0
Trade	2,513	2,784	2,851	7.2	10.8	2.4
Finance, Insurance & Real Estate	693	695	698	4.7	0.3	0.4
Services	2,537	2,651	2,728	8.2	4.5	2.9
Government	1,730	1,713	1,718	0.3	-1.0	0.3
Federal	332	339	341	1.1	2.1	0.6
State & Local	1,398	1,373	1,378	0.1	-1.8	0.4

A = Actual F = Forecast

nonresidential construction some time in 1986. Nevertheless, if the economy is able to avoid a sharp upward spike in mortgage interest rates, construction employment should enjoy good growth rates of 7.1 and 9.0 percent, respectively, in 1985 and 1986.

Another sector — hard hit by the 1981-82 recession — which experienced healthy job gains in 1984 was manufacturing. Manufacturing employment in California grew by 6.1 percent in 1984, adding 118,000 workers to payrolls. About eighty percent of those jobs were created in durable goods manufacturing. A great deal of the strength in manufacturing last year was attributable to the aerospace/electronics industries. Despite an existing slump in the computer and related industries, a steady flow of defense dollars more than helped pick up the slack. Somewhere between twenty to twenty-five percent of U.S. defense outlays in 1984 made their way to California-based defense contractors, adding a tremendous amount of economic stimulus to the state.

Prime defense contracts awarded to California firms were up 8.1 percent in 1984 over the previous year. Since the beginning of the Reagan administration's defense buildup in 1981, the volume of defense business in the state has doubled. Aerospace employment rose nearly 8 percent last year, adding over 50,000 jobs — about 44 percent of the total employment increase in manufacturing. Durable goods manufacturing was also helped by a strong upturn in spending for consumer durables, such as in homebuilding and home electronics. Despite a definite slowdown in the administration's defense buildup, aerospace employment in California will grow better than three percent in both 1985 and 1986 because of a heavy backlog of orders. Growth in manufacturing employment, meanwhile, is expected to be lackluster in 1985, mirroring a soft U.S. economy. Manufacturing employment will grow a weak 1.4 percent in 1985, and then rebound in 1986 to grow by 3.2 percent.

Employment in the finance, insurance and real estate sectors rose 4.7 percent in 1984 but the gains were uneven. Real estate employment increased by 9 percent, reflecting the strength of housing demand in its present low interest rate environment. Declining interest rates were also a source of strength for the once languishing savings and loan institutions, which also saw an increase in payrolls. Problem loans in the banking industry actually contributed to a decline in banking employment. Most of the banking industry's present problems, however, tend to be concentrated in several major institutions. Meanwhile, employment in transportation and utilities increased a comparatively small 3.3 percent. Holding down growth in this sector was the breakup of AT&T, with former employees reclassified to other employment categories.

Government employment was up a miniscule 0.3 percent in 1984, as part of a general trend toward fiscal restraint and a reduction of government activity at all levels. In fact, last year's small gain in government employment was the state's first increase this decade. From 1980 to 1983, total government employment in California fell 2.2 percent. This was in sharp contrast to the early 1970s when statewide government employment was growing anywhere from one and a half to five percent a year. Government employment is expected to increase very little over the next year and a half. In fact, government employment may be either flat or declining over the next several years. Employment growth in the transportation and utilities sector will be somewhat stronger, growing between two and three percent in 1985 and 1986.

PERSONAL INCOME

Total personal income in California will increase a moderate 7.9 percent in 1985, followed by an equally moderate 8.1 percent increase in 1986, outpacing the growth in personal income for the nation in both years. These rates of growth in personal income are in contrast to personal income growth in 1984, which grew at the exceptionally strong pace of 11.2 percent, totalling $371.1 billion — the state's largest dollar gain in personal income since 1981. Personal income in California is expected to reach $404.8 billion in 1985 and $437.0 billion in 1986. Fueling last year's tremendous burst in personal income was the strength of the economic recovery and its creation of large employment gains. By the end of 1984, total personal income in California accounted for 12.3 percent of all personal income nationally. Californians were also the beneficiaries of a 10.1 percent gain in per capita income in 1984, placing the state among the top five states in the union on a per capita basis. California's per capita income, as of the end of 1984, stood at $14,482.

Despite an overall increase in personal income, there were considerable differences among the various components. Total wage and salary gains were right in step with California's overall gain in personal income, rising 11.2 percent in 1984. Wage and salary income is an important component of statewide personal income, making up over three-fifths of the total. Other labor income — which consists primarily of fringe benefits — was up an even better 13.3 percent in 1984. While some of the increase in wages and salaries is explained in part by increased hourly earnings and hours worked per week, the bulk of the gains can be attributed to the

POPULATION AND PERSONAL INCOME

	1984A	1985F	1986F
Population (Thousands)	25,622	26,185	26,788
Net Migration (Thousands)	178	148	184
Personal Income ($ Billions)	371.1	404.6	437.2
Per Capita Personal Income ($)	14,482E	15,452	16,321
Disposable Personal Income ($ Billions)	322.3	345.2	372.9
1972 Dollars	142.1	147.6	153.7
Annual Rates of Change:			
Population	1.7	2.2	2.3
Net Migration	–27.9	–17.0	24.0
Personal Income	11.2	7.8	8.1
Per Capita	9.2	4.9	5.6
Disposable Personal Income	12.8	7.1	8.0
1972 Dollars	9.4	3.8	4.1

E = Estimated A = Actual F = Forecast

overwhelming number of jobs created in the state last year. To illustrate, total nonagricultural employment in the state increased by over 600,000 in 1984. Meanwhile, hourly earnings in manufacturing rose by only 3.0 percent, continuing a trend which has seen manufacturing obtain modest wage gains the past three years.

Overall, wage and salary gains have proven atypical during this current expansion. Foreign competition along with greater domestic competition in such industries as transportation and communications have helped keep wages rising more slowly than normally would be anticipated. One chief characteristic of lower inflation has been lower wage gains. In the late 70s and early 80s, manufacturing wages, *nationally*, were growing at 9.5 percent a year. In the last three years, workers' wages have risen at an annual rate of less than 5 percent. Wages are expected to continue rising modestly in 1985 and 1986.

Property income — which includes interest income, dividends and rents, and accounts for 20 percent of personal income in California — registered an exceptional gain of 13.9 percent in 1984. Leading the way was interest income, which climbed 15.7 percent, followed by income from dividends which came in 11.7 percent higher than in 1983. The huge jump in interest income was attributable to intermediate term investments made at high interest rates. Because interest rates have come down considerably since the summer of 1984, growth in interest income is assuredly slower in 1985 than the breakneck pace of a year ago. The gains made in dividends last year — the best performance of dividends since 1981 — reflected the strength of the economic expansion and its positive effect on corporate profits. As will be the case with interest income, the growth in dividends will also be of a smaller order in 1985. Part of the explanation lies with the anticipated slowing in the U.S. and state economies. In addition, the current disinflationary environment in which business finds itself today has put a squeeze on corporate profits and earnings. Profits have been slowing dramatically in the last year in contrast to their strong performance in the first two years of expansion. Deregulated markets have resulted in more competitive markets. Freer markets, in conjunction with intense competition from imports, will continue to hamper prices and profits alike in 1985. Income from rents rose a modest 5.4 percent in 1984, but are expected to rise faster in 1985 because of a strong demand for apartment housing.

Proprietors' income registered the largest percentage increase in personal income in 1984, rising 24.5 percent. Nonfarm proprietors' income rose 22 percent, and was chiefly a reflection of a strong economy. The category of nonfarm proprietors is largely composed of small businesses whose income is very sensitive to the ups and downs of the economy. Nineteen eighty four's strong performance encouraged many startups of small businesses and was a boon for services and retailers. In addition, the decline in interest rates has helped reduce financing expenses for many small businesses.

Farm proprietors did even better in 1984, experiencing a gain of 39.2 percent in their income. However, this percentage increase belied the difficulties facing California agriculture. The significant increase in farm proprietors' income was largely the result of substanial subsidy payments made during the first quarter of 1984, a pattern that is not expected to repeat itself in 1985. Worldwide overproduction in many commodities has led to falling prices in the industry, hurting producers. With commodity prices not expected to firm up a great deal in the immediate future, farm income will most likely remain flat in 1985 and 1986.

One notable change worth highlighting has been the steep descent in the growth of transfer payments. With consumer prices running well below five percent the past several years, transfer payments were up by only 3.9 percent in 1984, the smallest increase in over two decades. During the inflationary period of the late 70s

and early 80s, the cost of living adjustments in transfer payments automatically boosted benefits above the average annual increase in personal income. With inflation projected to remain under five percent in 1985 and 1986, the growth in transfer payments should also be modest.

Real personal income in California grew at the extremely fast pace of 7.8 percent in 1984. The precipitous drop in inflation over the past several years has allowed real disposable personal income to grow rapidly. Real disposable income gains in 1985-1986 will be on the order of four percent each year. The additional income was to a large extent responsible for the healthy gains witnessed in retail sales. California is expected to enjoy moderate rates of growth in real personal income for both 1985 and 1986 — 4.6 and 4.1 percent, respectively. The reason for the smaller gains is a slowing economy. Still, continued job growth should help bolster personal income a bit in 1985 and 1986.

CONSUMER SPENDING

Consumer spending in California has been very strong since coming out of the 1981-82 recession. Department of Commerce figures place *total retail sales* growth for California in 1984 at 9.2 percent, totalling $155.6 billion. More importantly, most of the gains in total retail sales were in real terms, i.e., without the effect of inflation. Durable goods sales increased by a whopping 14.2 percent in 1984. Nondurable goods sales, on the other hand, grew a modest 6.4 percent last year.

Sales growth was just about equally divided among the two major categories of retail establishments. Department store sales kept pace with overall retail sales growth, increasing 9.2 percent. Meanwhile, sales from general merchandise stores fared a bit better, growing 9.5 percent.

According to the California State Board of Equalization, *taxable retail sales* were up a buoyant 14.5 percent in 1984. Taxable sales last year totalled $194 billion. As was the case with total retail sales, most of the increase reflected higher unit volume, rather than higher prices. Real taxable sales were up 8.3 percent in 1984, the largest gain since 1977. Durable goods sales were up 16.6 percent, while nondurable goods sales grew only half as fast, at 8.3 percent.

Consumer spending's strong performance in 1984 is remarkable when viewed from where taxable retail sales were just three years ago. In 1982, the last year of the recession, taxable retail sales grew a sorry 0.3 percent. In contrast, taxable sales expanded 11.1 percent in 1983, and the previously mentioned 14.5 percent in 1984. Like the nation, California's consumers had developed a huge pent-up demand during the recession years. Upon the recovery's arrival, consumers went on a spending spree, lasting from 1983 through the first half of 1984. Sales growth in the first half of 1984 was especially strong, followed by a considerably softer second half. In the first two quarters of 1984, taxable retail sales were up 16.8 and 14.1 percent, respectively. The third and fourth quarters, meanwhile, posted comparatively smaller gains of 9.0 and 8.6 percent, respectively. Consumer spending in 1984 strongly reflected the large gains made in employment and, as a result, personal income. Higher interest rates and stock prices enabled consumers to enjoy an impressive buildup of liquidity. Interest income and dividends were up nearly 16 and 12 percent, respectively, in 1984.

Retail sales' strong showing in 1984 was led by a rebound in car sales, and continued strength in housing. That these two sectors should be in the forefront of the recovery is not surprising given how hard they were hit during the 1981-1982 recession. New car sales have been increasing annually since 1982 — paralleling California's economic recovery. Durable goods sales'

GROSS STATE PRODUCT TAXABLE SALES AND PRICES

	1984A	1985F	1986F
Gross State Product ($ Billions)	456.2	490.1	527.6
1972 Dollars	198.6	206.0	214.6
Taxable Sales ($ Billions)	193.9	212.5	229.9
Consumer Price Index	307.5	317.3	327.8
Annual Rates of Change:			
Gross State Product	12.5	7.4	7.6
1972 Dollars	8.4	3.7	4.2
Taxable Sales	14.7	9.6	8.5
Consumer Prices	5.0	4.5	4.5

A = Actual F = Forecast

very strong showing in 1984 was in large part traceable to car sales' impressive comeback. In 1984, motor vehicle registrations — a proxy for motor vehicle sales in California — reached 1.689 million, a 17.6 percent increase over 1983's total, and the second highest total recorded in the state in the past fifteen years. The bulk of these sales were for cars and trucks valued at $19.3 billion, a gain of 20.9 percent from 1983. The robustness in sales has been the result of several factors, the most important of which has been special incentive financing by auto makers, allowing many would-be car buyers to get into the new car market. These special incentives have usually taken the form of below market financing. As a result, consumers have been able to finance their purchases of new cars at interest rates far below market levels. In addition, the extension of the repayment period for new car loans to five years by some lending institutions — up from the traditional three or four years — has reduced the size of monthly payments and brought in the marginal buyer. New car sales thus far in 1985 appear to be in the neighborhood of last year's sales figures. The affordability of new cars and trucks will continue to improve slightly because of lower loan rates, but this influence is likely to be offset by higher prices for 1986 models. In addition, total car sales are likely to be stimulated as more Japanese cars are shipped into this country.

Sales of home related items have also done well, in response to the revitalized housing industry. That industry has witnessed an incredible growth in residential permits for new construction from its low of 84,000 in 1982, and concurrently has enjoyed a vastly improved resale market. Residential permits rose 100 percent in 1983 and an additional 30 percent in 1984.

The dramatic turnaround in housing has made a world of difference for many of housing's support industries. For example, taxable sales by building materials stores rose nearly twenty percent in 1984. The list of beneficiaries of the housing resurgence is long and varied and includes lumber and building material dealers; hardware; plumbing and electrical supply; and paint, glass, and wallpaper stores. The strong housing demand of the past two years has also been a bonanza for household furnishings stores which posted a gain of 13.2 percent in 1984. Housing will continue to exhibit substantial strength in 1985 and 1986, exerting its favorable impact on retail sales for many related industries.

Consumer confidence, which was a bit shaky in the first half of 1985, appears to be firming up as we move through the second half of 1985. A confident consumer is good news indeed for retailers. Consumer spending appears to be regaining some of its earlier momentum, perhaps boosting growth in coming months. Buying plans for major expenditures, which had seemed to be put on the shelf earlier, are back on the table and will hopefully keep the current recovery rolling. Interest in home buying is still running high in many parts of the state. With the demand for residential housing continuing to rise, major appliance and furniture store sales should maintain their heady pace. And, in the wake of the brief summer lull, automobile purchases should be back on track throughout the remainder of 1985.

Security Pacific Bank is forecasting taxable retail sales to grow by 9.6 percent in 1985, tapering off slightly to 8.5 percent in 1986. Retail stores sales are forecast to grow 8.0 percent in 1985, followed by a growth of 7.4 percent in 1986. The expected growth of taxable retail sales in 1985 is an indication of the resiliency remaining in consumer spending — despite a slowing in personal income growth and the economy as a whole. Despite declining overall growth in consumer expenditures, some categories will continue to expand at above average rates, such as services, durables, autos and parts.

The willingness of consumers to continue spending will, in large part, determine how strong economic growth shall be in the coming months. With jobs still plentiful and inflation low, consumers have been spending and borrowing freely. Consumer spending, with perhaps the exception of housing, has been the healthiest sector of the state's economy. Certainly retailers are counting on an upbeat consumer and the stimulus of lower interest rates to continue easing spending along.

CONSUMER PRICE TRENDS

The rate of inflation in both the United States and California has declined sharply during the past five years. In early 1980, consumer prices nationally were running at an annualized rate of 15 percent. Within three years however, consumer prices had come down by thirteen percentage points, reaching a low of 2 percent at an annualized rate by early 1983. Consumer prices in California rose 26.2 percent between 1981 and 1985. That figure is a far cry from the 1977 to 1981 period, when consumer prices rose 53.5 percent. Nationally, consumer prices increased 4.3 percent in 1984. In comparison, prices in California rose 5 percent. Two painful recessions, in 1980 and in 1981-1982, helped to reduce an inflationary momentum that had gotten out of hand during the late 1970s. In particular, the severe and protracted recession that

California experienced in 1981-1982 purged the economy of double-digit inflation and changed the behavioral patterns of businesses, labor and consumers.

Nevertheless, 1984's modest advance in consumer prices was surprising considering the strength of the economic expansion that year. Oftentimes, a sharp upswing in economic activity is accompanied by an acceleration in the inflation rate. California's favorable inflation experience benefited, no doubt, from the strong U.S. dollar which, together with deregulation and other factors, held U.S. prices and labor costs down. Also, deregulation of some key sectors of the economy, such as trucking and the airline industry, forced down the price of those services significantly in recent years.

Accounting for much of the rise in consumer prices in 1984 were residential rents and homeowners' costs in the three most populous areas of the state. Residential rent increases were quite substantial in 1984, pushing the state's housing component of consumer prices higher than the nation's. Because the consumer price index now uses the rental equivalence measure of homeowner costs, rather than the previous base of housing prices and mortgages, homeowners' costs actually increased faster than either the median price of a new home or interest rates.

In addition, fuel and utility prices rose very rapidly in certain parts of the state. Gasoline prices fell slightly in 1984 only to rebound in the first half of 1985. As a result of chronic overproduction in world oil supplies, there is still plenty of oil in the world's pipeline and much of it is making its way to the U.S. marketplace. Despite mild increases in gasoline prices earlier this year, oil prices are expected to decline later this year, bringing down pump prices with them. This is very good news for the United States since energy prices play a major role in many industries. For example, if energy prices were eliminated from the overall index in 1984, consumer prices would have been a half percent higher.

Food prices continue to remain relatively flat as a result of bountiful harvests and depressed commodity prices. Apparel and upkeep costs barely changed in 1984, as the industry continues to fend off a wave of cheaper imports which have held prices down in that sector. Medical care costs have done an abrupt about face to its spiraling cost increases of a few years back. In fact, medical care costs were actually lower in California than in the U.S.

A retrenchment in health care costs is extremely significant because of the better than 10 percent of GNP it represents. Part of the reason for the drop in health care costs was the introduction of the diagnosis related group (DRG) guidelines setting a price list of what Medicare, Medicaid and Medi-Cal would pay for each of 468 ailments. The three aforementioned government insurance carriers represent 52 percent of California's health care market. In addition, a burgeoning home care industry has played a role in helping trim the medical bills of thousands of patients who would otherwise remain hospitalized. A little more than forty percent of the nation's health care bill is specifically related to hospitalization. Because of a moderation in prices for such items as food, gasoline, housing and medical care, consumers today spend less of their after-tax income (expressed as a percent of total after-tax income) on essentials than they did during the rapid inflationary period of the late 1970s.

Inflation in both the U.S. and California is expected to remain contained over the next two years, staying below five percent in both 1985 and 1986. It is currently projected that consumer prices in California will rise 4.5 percent in both 1985 and 1986 — about half a point higher than what consumer prices are projected for the U.S. during the same two year period. The previously cited strong dollar is just one of several reasons why consumer prices in California and the nation are expected to be moderate in 1985 and 1986. Also helping to keep a lid on U.S. prices and wages will be the ever vigilant Federal Reserve, maintaining an aggressive stance in its role to control inflation while fostering economic expansion.

Oil and food prices, which had been major impetuses to earlier inflation, have been weak of late in the face of agricultural overproduction and a glut in the world's oil supply. Recent oil price cuts by Mexico will only add to the current downward momentum in worldwide oil prices. Mexican oil accounts for nearly 14 percent of U.S. crude imports. Hence a drop in Mexican oil prices is likely to exert a deflationary influence. In addition, a severe oil price decline might well spread to other commodities. Finally, deliberate government policies, both at home and abroad, will seek rates of economic growth that are compatible with moderate rates of inflation. ■

CALIFORNIA INDUSTRY TRENDS

AEROSPACE/HIGH TECHNOLOGY

California was the nation's largest recipient of military spending in 1984, with defense expenditures topping $50 billion. With an estimated gross state product of $450 billion, one out of every nine dollars generated in the state in 1984 was attributable directly to defense expenditures. Overall, it is estimated that some 15 to 20 percent of the state's 1984 economic growth was attributable to the increase in defense-related production. In 1985, another $50 plus billion will be injected into the state's economy, including an estimated $35 billion worth of defense aerospace contracts — one quarter of the nation's total.

Defense is one of California's basic industries, generating employment and income, while stimulating growth in dependent industries such as housing and services. In 1984, over 700,000 persons were employed statewide in the defense-aerospace sector of the economy. Department of Defense economists find that each additional $1 billion in prime contract volume creates 28,500 new direct jobs, plus 7,500 indirect jobs supported by defense activities, for a total of 36,000 jobs. Additionally, each $1 of final demand in defense spending yields a multiplier effect of between $2.00 and $2.50 for the economy.

In an effort to put the importance of aerospace into perspective, the following is a thumbnail sketch of some of the aerospace contractors in the state. Of course, there are many more contractors than could be mentioned here. Hughes Aircraft, the 7th largest defense contractor in the nation, involved with weapons and military and commercial electronics, employs 68,500 California workers, making it the largest industrial employer in the state. Based in El Segundo, Hughes is the state's largest manufacturer of radar and satellites, and the second largest manufacturer of tactical missiles. Northrop, a prime contractor for the stealth strategic bomber, is also the designer of the F-20 Tigershark and is involved in technologies essential to the next generation of weapon systems, lasers, unmanned weapons, and electronic warfare equipment. Northrop, and other major aerospace firms are aggressively hiring engineers in a generally robust job market to meet the increasing demands of the Pentagon. Lockheed Corp. has as many as 10,000 workers building a new fleet of aircraft utilizing stealth technology and is doing work on the Trident missile. TRW, Inc., in the Redondo Beach area, employs 17,000 workers building secret spy satellites. Lockheed, McDonnel Douglas and Rockwell International all have rapidly accelerating aircraft programs. A McDonnel Douglas subsidiary in Long Beach, California has received funding for work on a prototype $40 billion C-17 transport jet and is currently developing sea launched cruise missiles. McDonnel Douglas, along with Rockwell, has also received millions of dollars in contracts to design NASA's manned space station. Rockwell is already involved in work on the space shuttle, the B-1 bomber, and the MX missile. Many of the above aerospace firms also stand to gain a lion's share of the contracts from the president's strategic defense initiative (Star Wars) program. Most defense and aerospace contractors view winning work on the project as an important step in getting additional work in the growing militarization and commercialization of space.

Because of the great concern over federal budget deficits, it is unlikely that there will be any further acceleration in the U.S. arms buildup. Nonetheless, because of the more than 12 percent growth in military spending in both 1981 and 1982, present defense outlays will be more than adequate to sustain employment levels in the state through the remainder of President Reagan's second term in office. Much of the budget authorities for major weapon systems approved by Congress earlier remains unspent. Production is just beginning to hit full stride for many major weapon systems procured earlier. The backlog of billions of dollars of funds appropriated in earlier years — but not yet actually spent on defense programs — will ensure that current defense spending levels continue into the early 1990s. In view of the aforementioned, it is safe to conclude that, despite budget constraints on future defense expenditure growth, military spending will continue to remain a major economic force in the state through the rest of this decade.

Not all growth in the aerospace industry has been solely the result of military spending. Commercial jet makers made a dazzling recovery in 1984 after being mired in a 1982-83 slump. In 1984 there was a total order of 323 commercial passenger jets. Boeing Co., Lockheed Corp., and McDonnel Douglas Corp. combined are projected to sell 287 commercial passenger jets in 1985, after about 185 in 1984. The improved profitability of airlines as a whole has resulted in the pickup in orders. Steady increases in airline passenger traffic, dropping fuel prices, and a dwindling number of used aircrafts for sale, have all been music to the industry's ears. These facts, in combination with cost cutting measures introduced by the airlines, less expensive labor agreements, and the offering of discount rates encouraging discretionary travel, are all expected to result in airlines ordering more planes through 1985 and early next year. In addition, a surge of new orders from internatonal carriers is expected.

California's high-tech industries, on the other hand, have been taken aback by recent developments of the past year. Flagging demand and excess capacity have hurt many high-tech industries in 1984. The computer and related industries have been particularly hit hard by months of massive layoffs and crumbling earnings. The cooling off in economic growth this year is likely to exacerbate the current situation, causing individual businesses to hold off on investing in office and computing equipment. In Santa Clara County, the heart of Silicon Valley, employment among computer and electronics firms has dropped after nearly two years of steady gains. U.S. high-tech firms, which generate 30 to 40 percent of their sales abroad, have also been hurt by the dollar's steady rise, making American goods more expensive overseas and imported products more attractive here. A turnaround is not expected until late 1985 or early 1986. Until then, business failures and employee layoffs will continue.

Two major problem areas in the high-tech sector are computer manufacturing, with too many producers chasing too few buyers, and the semiconductor industry, where a glut of chips exists from overordering in early 1984. Chip makers, besieged by massive customer stockpiling in 1984, and faced with an enormous amount of new capacity coming online in 1985, are in for a very bumpy ride. With so much new capacity onstream, many of the more than 250 producers will fall deeply into the red and some will drop out completely. Particularly worrisome has been the continuing slowdown of growth in the personal computer industry which consumes some 10-15 percent of the semi-conductor output. Sales have plummeted for producers of tiny chips that are essential to computers and communication devices. Equally troublesome for the industry has been a sharp decline in prices resulting from intense competitive pressures from abroad.

Microchips are a key component in a wide range of industrial and consumer products, ranging from computers, telecommunications and process control equipment to cars, audio/video products and cameras. The weakness in the electronics market is pervasive. Orders for computers and office equipment are down about 20 percent from a year ago. Commodity producers, which turn out large amounts of standard products, are expected to be hit the hardest. But even manufacturers with strong specialty and proprietary lines will experience a tough time.

The impact of foreign competition, especially Japanese, is also of ongoing concern. Japanese producers already have a 41 percent share of the global semiconductor market and as much as 18 percent of the U.S. market. Japanese competition has been cited as a major reason why domestic producers have been cutting back on production. Moreover, the strength of the dollar inflates the cost of American goods in foreign markets, resulting in lower exports, and layoffs and plant shutdowns in the U.S. In every major U.S. electronics market, imports are rising while exports are falling. In 1984, for the first time ever, the nation's electronics sector registered a $6.8 billion trade deficit. Nineteen eighty five's trade deficit in electronic products should hit at least $12 billion. There has been much clamoring for trade protectionism by the industry in recent months. However, a major reduction in the federal budget deficit would likely have a more favorable impact for the industry by putting downward pressure on the dollar.

Not all of high-tech has been doing poorly. With personal computer sales in hibernation, computer makers are moving into the office automation market, i.e., tying all office equipment into a cohesive system. This market is projected to generate sales of $9 billion in 1985, and to reach sales of $40 billion by 1988. Another growth area for computer vendors will be small businesses with less than a hundred employees. Only one-third of these businesses currently use computers in their office, in contrast to 85 percent of firms with over 1,000 employees. Sales of business software for computers remain healthy, but the huge growth spurt of the past five years is expected to slow by the end of the decade. Annual sales growth had been averaging 104 percent over the past five years, but is expected to average only 26 percent for the next five years. Personal computer software sales are projected

to total $6 billion by 1988 as more than 15 million new personal computers are expected to reach office and home desk tops. Artificial intelligence applications are expected to account for a large portion of the next generation of personal computer software. Software that allows the user to enter commands in simple English, as well as software that stores specialized knowledge, will do quite well. Demand for PC software will continue to be robust for the next three to five years and the companies that will benefit will be the ones that can improve upon the state of the art.

Still, the events of the past year in California's high-tech industry still leave one with the inescapable conclusion that high-tech is no different from other large manufacturing industries: it's large, vertically integrated, and susceptible to cycles. During the late 1980s and early 1990s we expect to see a further shakeout of weak competitors and a stabilizing of the top tier of manufacturers. A shakeout will occur in the next five years as the market matures.

TOURISM

With a well developed tourist business and a broad range of attractions, tourism in California is a major source of employment and income for the state. Over half a million Californians are employed in tourist-related occupations, about five percent of total state nonagricultural employment. Nearly two-thirds of tourism employment is concentrated in the food and lodging services sector. Tourism, however, creates employment in transportation, recreation, retail trade and travel arrangement activities. In addition, payroll figures in 1983, the latest year for which data are available, amounted to $6.1 billion. U.S. travel related spending in California was placed at better than $25 billion, with business travel accounting for one-fifth of the total. Californians traveling within the state accounted for 54 percent of the $25 billion in travel expenditures. Los Angeles County led all California counties in travel receipts with $8.1 billion, or nearly one-third of the state's travel expenditures.

In addition, foreign visitors spent $2.63 billion in the state. Foreign travel expenditures account for ten percent of California's tourism income and employment. Twenty percent of all international visitors into the U.S. visit California. Almost half of all foreign visitors into the state are from three countries alone: Mexico, Canada and Japan. Travel related expenditures generate nearly a billion dollars in state revenue, approximately four percent of all state tax collections in 1983, and slightly more than $500 million in local revenues.

The impact of travel expenditures on California's economy are incredibly broad. Travel in California generates demand for many different goods and services and produces receipts for a number of different industries such as retail and service establishments located throughout the state. One of the most important benefits of travel and tourism is the employment which this activity supports. On the average, every $50,000 spent by travelers in California directly supported one job during 1983, and each tourist dollar produced $.23 in wage and salary income. Tourist expenditures are a significant part of the following industries: air transportation; eating and drinking establishments; gasoline service stations; hotels/motels; amusement/recreation services; general merchandise; auto rental; builders; automotive dealers; taxicabs; camp/trailer parks; intercity highway passenger transportation; and rail transportation.

Since its low point during the 1982 recession, tourism has been on a moderate growth path. The turnaround in the economy in 1983-84 and its concomitant rise in employment and income, was thought to have moved the travel business smartly ahead. However, in 1984, travel and tourism in California failed to gain significantly in spite of a strengthening economy which saw consumers spending and many businesses expanding. Many hotel markets in Southern California were especially depressed a year ago because of the tremendous amount of overbuilding that took place for the 1984 summer Olympics. As a result, occupancy rates were down 9.5 percent in Los Angeles County and a whopping 32.3 percent in Orange County the week after the Olympics, versus the same period a year earlier. Hotel occupancy rates in the Los Angeles metropolitan area, an indicator of travel activity, were slightly lower in the first six months of 1985 over the same period last year. Food and beverage operations continue to struggle in attracting patrons into the hotel restaurants. The cost of eating in restaurant facilities continues to rise in spite of the declining number of people eating at the facilities. The decline in hotel restaurant goers can be traced partly to declining occupancy rates. However, rising menu prices may also have met consumer resistance.

Nevertheless, tourism in California is beginning to make its way out of last year's doldrums. Industry sources suggest that 1985's summer travel volume was above levels reached last summer, with beaches remaining the favorite destination. Normal travel

patterns are believed to have resumed this year as a result of California's continued economic strength and small gains in travel costs. A good summer for most sectors of the travel industry is being reported. Theme park operators are optimistic about summer attendance figures, with many looking to a possible record for the first time in 5 years.

While the U.S. economic recovery is anticipated to continue through 1986, growth rates will be well below 1984's strong pace. A strong economy tends to encourage travel. Business travel will be down because of budgetary pressures in many U.S. companies. On the other hand, falling oil prices and strong competition on major air routes will continue holding down transportation costs, encouraging travel.

As a discretionary spending decision, travel plans are heavily influenced by other factors. For example, the recent economic recovery produced a pronounced increase in durable goods sales. By contrast, what many in the travel industry called a pent-up demand for domestic travel failed to materialize. Pursued by a multitude of sellers, consumers have not always chosen travel as a top priority. The current trend in leisure time activities is toward less travel and more home-based activities. Demographic changes will tend generally to support increased travel over the next few years however. The baby boom generation is entering peak earning years and their vacation time is increasing. In addition, the number of older citizens is expected to increase, and many have the time and money to travel.

Finally, in 1985, California's Office of Tourism launched the creation of a California marketing plan themed the "Californias." With a budget of over $5 million, the expressed purpose of the state's new marketing plan is to do a better job of selling California to prospective visitors and businesses. The chief objective is to increase California's U.S. tourism market share which has remained flat over the last four or five years. Contributing to the state's declining share of visitors has been the aggressiveness shown on the part of other states. The strength of the dollar has decimated international travel, and competitive tourist packages by other states are competing for California's travel dollars. In addition to enticing more foreign visitors, state tourism officials hope to lure visitors from surrounding states, and to persuade more Californians to do their traveling within the state. With California's new tourism development budget, the state now moves from near the bottom to among the top ten states as ranked by travel promotion budgets. The Office of Tourism hopes to advertise not only well known major attractions in the state, but also some of the currently lesser known and visited areas of the state. Tourism in California is presently concentrated in the major metropolitan areas with nearly three-fourths of all visitors' expenditures occurring in Los Angeles, San Francisco, San Mateo, San Diego and Orange Counties. Nevertheless, tourism is very important in many outlying regions of the state. The promotion of tourism in these less frequently visited areas is a prime objective of the marketing plan. In all, the five-year plan is intended to increase visitor trips to the state by five percent a year, and travel expenditures by some $236 million annually. That level of expenditures is estimated to lead to the creation of 4,300 new jobs per year.

CALIFORNIA AGRICULTURE

The agricultural industry is a sector in California that has not participated in the general economic recovery. Persistently depressed commodity prices have burdened producers who borrowed heavily in anticipation of increasing market prices. In addition to weak export demand, both domestic and foreign agricultural producers have flooded the world with surpluses of most commodities.

Cash receipts for 1984 agricultural products in California totalled $13.8 billion, up a mere two percent from the previous year. While the volume of overall production was higher last year, weak market prices held the increase in cash receipts in check.

Field crops registered the largest gain in production. This gain was a result primarily of acreage returned to production following the 1983 "payment in kind" program, a federal acreage diversion incentive.

Production of fruit and nut crops decreased significantly in 1984 but, despite this reduction, depressed market prices resulted in lower cash receipts as well. Leading causes were a record almond crop, persistent surplus grape production, and deciduous fruit harvests that were hurried to markets by extremely hot weather.

Both cash receipts and production of livestock and livestock products increased in 1984. The higher cash receipts were generally a result of greater production rather than higher commodity prices. The sales of milk and milk products managed to increase slightly despite USDA efforts to reduce such production nationwide.

While the value of agricultural exports produced in California are expected to show a slight increase in 1984 compared with 1983, the export activity is still depressed compared with the level seen prior to 1982. As a result of reduced marketings and lower commodity prices, 1983's agricultural exports at port of demarkation amounted to $3.1 billion, a 26 percent decline from its peak of $4.2 billion in 1981. While California crops, such as cotton and almonds, which lead the list of export commodities registered higher levels of production, prices received were much lower than the preceding year.

The extremely high value of the American dollar continued to make California agricultural products less competitive in 1984. In addition to weak economies abroad depressing such foreign sales, protectionist trade barriers and subsidies continued to impede agricultural exports from California.

The increase in the costs of inputs for production kept similar pace with the overall low inflation experienced in 1984. While prices last year for fertilizers, electricity, pesticides, and labor registered modest gains, the cost of fuel declined because of depressed oil prices worldwide. Overall, interest charged on borrowed money for California's agricultural producers was the same as the preceding year. However, many borrowers experienced higher financing costs because of increased debt levels.

As a result of slightly higher production costs and depressed market prices, net income for California growers has continued an overall decline. In fact, 1984 was the fourth year of decreasing net income statistics for the agricultural industry in California.

The poor profitability of California agriculture during the eighties has smashed the income expectations of investors in agricultural real estate. While it is difficult to measure the actual depreciation of farm land in California because of ag real estate sales inactivity, overall values are estimated to be significantly less than that for 1981 and previous years. In 1984, while open ground suitable for permanent crops declined modestly in value, many vineyards and orchards experienced as much as 50 percent depreciation because of particularly depressed commodity price prospects. However, some properties, such as oranges and coastal vegetable acreage, has maintained its value because of better market conditions. Such asset depreciation has depleted further the equity of many farming operations, especially those with mounting debt burdens.

Production conditions for 1985 have progressed normally. The winter provided a good period of dormancy compared with warmer winters of preceding years, and an early planting season has boosted yields of most crops. Numerous days of high temperatures have not had the same damaging effects as last year's heat waves.

Unfortunately, higher yields and greater production in other parts of the country and world have depressed field crop prices. The leading field crop, cotton, has seen its market price plummet this year because of surplus production domestically, foreign textile imports, and increased production in the People's Republic of China and in Australia.

With the exception of very poor almond prices, down by about one third from peak 1983 levels, most fruit and nut crops have benefited from slightly higher commodity prices in 1985. Lower yields in California and crop damage in other producing states have strengthened markets for many fruit crops.

Lower feed costs have benefited livestock producers. This trend is extremely helpful in light of persistently weak market prices for beef, eggs, and poultry. The market for milk and milk products has stabilized this year because of slightly increased retail sales and increased production of cheese products in California.

Production costs, excluding interest, are expected to rise by the same modest rate as last year. However, less than normal precipitation has increased irrigation costs since many growers have found it necessary to substitute ground water for surface supplies. Short term interest rates paid by California farmers have declined substantially from 1984 levels, benefiting financially troubled producers. However, long term rates have not declined and, in fact, the real estate lenders of the Cooperative Farm Credit System have increased their loan rates. These high long-term rates are a result of poor expectations for farm sector profitability.

Despite the relatively stable production costs, net income will continue its slide downward because of the poor prospects for market prices received by agricultural producers. This slide is extremely troublesome for the one out of three farmers, those who have debt to equity ratios of greater than 50 percent. Much public attention has been given to the financial difficulties of such growers and their problems in servicing such heavy debt burdens in light of poor profit prospects. Many agricultural lenders in California have found it necessary to classify a sizable portion of their

agricultural loan portfolio as nonperforming and, in some instances, acquire the collateral or to insist upon more capital. Many growers have found it necessary to liquidate some of their assets to reduce their extremely leveraged positions.

Greatly depressed market prices will continue to cause more depreciation of farm real estate values, especially open land, because of poor field crop prices. These depressed commodities markets are bearish for other commodities as well since producers will seek more profitable alternative crops. The financial squeeze is expected to persist for much of the California agricultural industry until sufficient numbers of uncompetitive producers leave the market, debt burdens are reduced, and sales increase as a result of lower commodity prices and greater marketing efforts.

While the U.S. dollar has depreciated significantly during 1985, the benefits will not be realized immediately. Foreign buyers must first deplete their existing inventories and adjust to the changing price differential between American agricultural products and those of other producing countries. Additionally, much more needs to be done about impediments to fair trade with other countries to boost California ag exports.

While much of the attention has been focused on the problems of agriculture in California and other states, the majority of growers in California are continuing to be profitable and keep current with their debt requirements, despite lower margins and asset values. Assuming that a more market oriented farm policy is adopted by the federal government and the overall recovery continues, California agriculture should become more profitable following the current restructuring of the industry. Such a stabilization in the California farm sector cannot be expected before 1987 and a rebound may take longer.

INTERNATIONAL TRADE

Since 1970, the volume of trade through California's customs districts has more than tripled. The value of this trade is presently equivalent to 18 percent of California's gross state product. The total value of the state's two-way trade increased 21 percent from 1983 to 1984, to nearly $81.5 billion. According to California's Department of Finance, anywhere from 60 to 70 percent of California's custom district trade is directly attributable to California. Reflecting the national pattern, international trade through California's ports and airports during the past couple of years has been characterized by rapid import growth relative to the export pace. The relatively slower rate of economic recovery by foreign trading partners, the strength of the U.S. dollar and restraints to trade have held back overseas demand for U.S. products while stimulating imports.

The value of California exports increased about 10 percent during 1984, while state imports jumped nearly 30 percent. Electrical machinery and equipment represented the largest share of imports into the state. Transportation equipment — primarily motor vehicles — accounted for the second largest share of California imports. Other major import categories included apparel, petroleum and natural gas, opticals and scientific instruments. Meanwhile, machinery and mechanical equipment comprised the largest share of California exports. Electrical machinery and equipment accounted for the second largest share of the state's exports. Other major categories of exports included transportation equipment — primarily aircraft — opticals and scientific instruments, and petroleum and natural gas.

Because of the state's proximity to the Far East, Pacific Rim nations account for roughly 75 percent of the total trade through the California customs districts. Japan is California's single largest trading partner in the Asian region, with total trade topping $28 billion in 1984 — more than one-third of the state's total. Total value of the state's exports to Japan increased about 12 percent in 1984. The weak increase in total export activity resulted in part from a decline in the important aircraft exports category. Imports from Japan increased more than 35 percent last year, benefiting significantly from the strong U.S. economic recovery as well as from the highly valued dollar. One trend that could limit the rise in Japanese import activity over the longer term is increased manufacturing by Japanese companies in the U.S. — either directly or through joint agreements.

California's top Asian trading partners, aside from Japan, are Taiwan, South Korea and Hong Kong. California traded nearly $7 billion in goods with Taiwan in 1984, up 26 percent from 1983. Imports from Taiwan increased 34 percent, while California's exports to Taiwan rose only 7 percent. Similar to the pattern with Taiwan, imports from South Korea into California rose 37 percent in 1984, while exports grew only 4 percent. Two-way trade with Korea neared $6.4 billion in 1984. California's trade with Hong Kong amounted to $3.8 billion in 1984. Growth in the value of California's exports to Hong Kong reached a strong 20 percent last year, far greater export growth than the other three large Asian trading partners.

CALIFORNIA'S LEADING TRADING PARTNERS, 1984
($ Billions)

	Imports	Exports	Total
1. Japan	30.4	7.7	28.1
2. Taiwan	5.2	1.8	7.0
3. Republic of Korea	3.6	2.8	6.4
4. Canada*	3.0	3.1	6.1
5. Hong Kong	2.3	1.5	3.8
6. Australia	.5	2.8	3.3
7. Singapore	1.5	1.8	3.3
8. Mexico	1.5	1.6	3.1
9. West Germany	1.9	1.1	3.0
10. Malaysia	1.5	1.3	2.8

Source: U.S. Department of Commerce, Security Pacific International Trade Databank.
*Canada's trade figures provided by Canadian Consulate General.

Outside of Asia, Canada is California's leading trading partner. The Canadian Consulate reported 1984's trade with California to be $6.1 billion as measured by their point of origin and ultimate destination data. While U.S. Department of Commerce statistics show that international trade between Canada and California amounted to only $1.5 billion in 1984, those statistics greatly understate California-Canadian trade since they include only the goods clearing customs in California. New trade negotiations between the U.S. and Canada are expected to enhance California's access to Canadian markets.

Mexico is California's eighth largest trading partner, with total two-way trade nearing $3.1 billion in 1984. However, only 10 percent of the total U.S.-Mexico trade passed through California last year, with more than 80 percent of that trade through the San Diego customs districts. Imports from Mexico into California totalled $1.5 billion. Still, California posted a $57 million trade surplus with Mexico last year.

California's trade with western Europe reached $11 billion in 1984. California's largest European trading partners in descending order were West Germany, The United Kingdom, France and Italy. Of the four, France and the U.K. imported more goods from California than they exported to the state. Two-way trade between California and western Europe increased moderately from 1983 to 1984, with electronic products, instruments, and transportation equipment the major commodity categories. West Germany, the leading European trading partner for California, ranked ninth among all of the state's trading partners. Two-way trade amounted to almost $3 billion in 1984, with California exports slightly more than one third of the total. The extraordinary rise of the dollar against the mark after the 1981-82 recession helped to slow trade growth between California and West Germany. Aggravated economic conditions in West Germany also contributed to the weak growth in California's export activity. Exports to West Germany grew only 10 percent while the growth in imports was nearly double that rate. In 1984, California-United Kingdom bilateral trade increased 9 percent to total almost $2.4 billion. Contrary to the pattern for most other trading partners, California's exports were $600 million greater than its imports from Britain, with export growth moderately outpacing import growth.

Two-way trade between California and France increased 16 percent in 1984, with the growth in imports from France into California far outpacing the growth in California exports to France. Near-term opportunities for California exports to France seem to be mostly in those sectors where French products incorporate U.S. parts (i.e., aerospace, motor vehicles and electronics).

Trade with Italy showed considerable growth from 1983 to 1984, boosted by Italy's recent economic expansion. Italy receives mostly machinery, electronics and aircraft from California. California, on the other hand, imports significant quantities of jewelry, footwear and wearing apparel from Italy, with these categories accounting for about a third of total imports from Italy through the state's customs districts.

The outlook for California's trade is partly contingent on the performance of the U.S. dollar. A strong dollar makes imports less expensive in many cases than domestically produced goods. The impact of the dollar has been evident in California's electronics industry, where several firms have reduced or suspended operations in favor of overseas production. Conditions could improve with greater economic expansion overseas and a declining value for the dollar. Figures thus far for 1985 show some depreciation in the dollar's value, but even in the unlikely event that the dollar depreciated rapidly, a pick-up in trade activity would lag. California's export trends through 1985 will again be slowed by foreign economic activity, and by a highly valued dollar. Export growth in 1985 is anticipated to be similar to last year's 10 percent increase. The growth in imports should once again outpace export growth this year, albeit well below last year's 30 percent gain. This

CALIFORNIA'S PRINCIPAL EXPORTS
($ Billions)

	1984
1. Machinery & Mechanical Equipment	7.3
2. Electric Machinery & Equipment	6.1
3. Opticals, Scientific Instruments & Photographic Equipment	2.4
4. Aircraft & Spacecraft	2.1
5. Cotton	1.5
6. Petroleum, Natural Gas & Products	1.3
Other	11.5
Total	32.2

Sources: U.S. Department of Commerce, Security Pacific International Trade Databank.

expectation results in part from slower U.S. economic growth and the fact that much of the strong dollar's impact on U.S. import activity has already been realized.

Over the longer term, California's international trade prospects are promising, although growth trends in the next few years should remain well below the double-digit annual rates of the late 1970s. Asia's rising share of U.S. trade will continue to benefit California, as the state is the principal U.S. gateway to the Far East. It should be remembered that international trade bolsters

CALIFORNIA'S PRINCIPAL IMPORTS
($ Billions)

	1984
1. Electric Machinery & Equipment	13.3
2. Machinery & Mechanical Equipment	8.2
3. Motor Vehicles	6.5
4. Wearing Apparel	2.6
5. Petroleum, Natural Gas & Products	2.0
6. Opticals, Scientific Instruments & Photographic Equipment	1.9
7. Metals, Alloys, Basic Shapes & Form	1.9
Other	12.9
Total	49.3

Sources: U.S. Department of Commerce, Security Pacific International Trade Databank.

not only directly-related producers of export goods, but also many other transportation, service, and financial sectors of the economy. Similarly, while the rapid growth of import activity has led to deficits and their associated problems, this trade activity also benefits a wide range of businesses in the state.

California also stands to gain from another major axis of U.S. trade: the North-South trade with Canada, as well as with Latin American countries such as Mexico, Brazil, and Argentina. Canada was once again the nation's leading trading partner, and trade between California and Canada will no doubt continue to be strong. Prospects for trade growth with Latin American countries should also improve over the long term.

CONSTRUCTION

California's strong economic performance in 1984 was no more evident than in the construction industry. Last year, residential building permit activity increased 29.5 percent while nonresidential construction valuation climbed a heady 20.7 percent. Resulting from this surge in residential and nonresidential construction, employment in the construction industry rose an incredible 20.6 percent, adding 75,900 workers in 1984. Overall, total valuations for building permits authorizing construction in the state increased 23.6 percent, totalling $26.5 billion. The growth in construction spending will be a bit more restrained in 1985, in line with the slower pace of the economy. In 1985, total building permit valuations are expected to be just under $30 billion for an increase of 12 percent.

Everything is in place in 1985 for California to have its best year in residential building permits since 1977, when over 277,000 permits were issued. Despite a generally slowing economy, residential building permit activity in California will continue its very strong upward trend. The combination of lower mortgage interest rates for owner-occupied homes, an abundant flow of funds, and accelerated depreciation for rental units is expected to make 1985 the best housing year in this decade. A bit of caution should be noted however; any larger than expected increase in interest rates and/or extreme investor concerns about upcoming tax legislation will definitely impact upon construction activity in the state. Provided that interest rates and the economy remain stable, the construction industry will continue to be one of the state's strong points.

The single most important factor in determining future trends in housing is the performance of mortgage interest rates. Falling interest rates lower the cost of home

ownership, thereby spurring demand for housing. With average mortgage interest rates lower in 1985 than in 1984, and with the rate of household formations at near record levels, housing demand will be a source of strength throughout the rest of 1985 and well into 1986. Lower mortgage interest rates, already at their lowest levels in five years for fixed-rate home loans, are part of a general decline in money market interest rates attributable to a weaker U.S. economy.

Security Pacific is forecasting a drop in mortgage commitment rates on long-term fixed-rate mortgages from 12 percent to 11.75 percent. Throughout all of 1986, mortgage interest rates will climb in a slow and gradual fashion to 13.00 percent by December of 1986. The reason for the pickup in rates will be a strengthening economy. For 1985, Security Pacific is forecasting residential permits totalling 240,000, with 110,000 of those permits for single units, and 130,000 for multiple units. In 1986, residential permits will decline to 220,000, with singles and multiples divided just about equally.

Historically, single-family home construction in California has accounted for about 60 percent of all residential construction. However, this gap has been disappearing in recent years to the point where over fifty percent of residential construction is now for multiples. The population of renters has grown for several reasons. For most people, owning a home, even with the recent deceleration in home price inflation, is still too expensive. Real estate investments are no longer as profitable as they once were because of the flattening in home prices and the lowering of tax rates. The increase in multifamily construction is also partly attributed to the enactment of the 1981 economic recovery tax act giving developers a more generous depreciation allowance. While single-family detached homes remain the first choice of most Californians, rental properties will continue to predominate in the denser, urban areas where houses tend to be higher prices. As the demand for living space increases in California's desirable coastal and urban counties, apartment and higher density construction will expand. Multifamily housing activity is expected to remain strong until the late 1980s, when demand from persons in the 18 to 25 age bracket, the prime age group for renters, tapers off sharply. Commensurately, persons in the middle and older age brackets, the prime age groups for purchasing homes, will be expanding. For now, the increase in the number of renters has, in turn, meant increased rents, making apartment ownership more profitable than in recent years.

It is further anticipated that the low interest rates of the first half of 1985 will spur employment and income through the second half of this year, causing demand in housing to pick up even more. In addition, demographic factors will play a larger role in home building demand over the next several years. The continued influx of immigration to the state will add significantly to this pickup in housing demand. Meanwhile, a large segment of the baby boom generation has reached the prime age period for home buying. Home price inflation, which rose at a phenomenal rate in the late seventies is expected to grow at a more gradual pace. A more realistic appreciation of 3 to 5 percent is anticipated. The increased availability of fixed rate mortgages and greater public acceptance of adjustable rate mortgages has made borrowing for the purpose of purchasing a home affordable to many Californians again. The flexibility gained by the actual and de facto deregulation of financial institutions and the ready availability of cash from foreign and domestic sources has proffered hundreds of new instruments to raise capital.

Both residential and nonresidential construction is being buoyed this year as a result of stable labor and material costs, a favorable overall inflation rate, and moderate interest rates. Developers have been capitalizing on an improved financial climate. Construction costs, meanwhile, are edging up only slightly higher this year. Last year's twin pressures of unemployment and burgeoning nonunion growth helped keep the lid on many wage hikes. In addition, the year 1984 was the first time that the number of wage freezes and rollbacks was greater than the number of increases in new labor pacts. Despite concerns that there will be efforts made on the part of laborers to recover lost wages and benefits in 1985, moderate wage increases for the industry as a whole are expected to prevail.

California's tremendous explosion in commercial development — in addition to lower borrowing costs — has been the result of a resurgence of interest in downtown locations and the growth in office populations, i.e., those jobs associated with office work. However, commercial development is extremely cyclical, with a shortage of space triggering a stream of new buildings flowing into the market two or three years later whether the market needs the added space or not. Major metropolitan areas in the state are already laden heavily with vacant space, with no immediate let up in sight for new building construction. This tremendous glut of commercial construction has resulted in the lowest commercial rents in six years.

Some commercial markets will continue to be flooded with developments for another year or two as developers race to capitalize on tax incentives and the mushrooming office space needs of high tech and other growing service industries. For several years now developers have been building without any tenants, in anticipation of a demand which may or may not be there. This overhang in office space is expected to improve somewhat by 1987. The oversupply will soften even in those markets with very strong local economies. Despite the tremendous amount of commercial construction that has taken place in California over the past several years, the state's position is not nearly as bad as some severely overbuilt cities, such as Denver and Houston. However, due to the extraordinary building boom of the past several years, vacancy rates are running higher than the national average in many California cities. Nationally, vacancy rates are averaging 15 to 17 percent. Until the market correction is fully resolved, it will be a tenants' market with perks for tenants continuing at an aggressive pace as owners compete for occupants.

While the construction boom has shown signs of slowing down, construction activity can still look forward to continued strength for the remainder of 1985 and in 1986. As mentioned, commercial construction can expect to see a smaller rate of increase this year as a result of all the new office space already planned or under construction. Manufacturers, meanwhile, will be making up for years of slow economic growth that deferred modernization and plant replacement. New awards for industrial construction should continue their upward trend this year. Alterations and additions to older commercial buildings will get a slight boost from the stabilization of commercial land values which will lead to more rehabilitation of older structures. In addition, as more cities seek to restrict the square footage of newer commercial buildings, the more spacious, existing older structures will become more desirable and will be targeted for revitalization. However, a tax provision in the President's reform package doing away with preferred tax treatment concerning older structures could more than offset this movement toward rehabilitating older structures.

Refinery construction will be weak, mirroring weak oil prices. Construction in the health care market will be somewhat depressed as hospitals become torn between wanting to have the latest technology and their efforts to contain escalating health care costs.

CALIFORNIA CONSTRUCTION FORECAST

				Annual Rates of Change	
	1984A	1985F	1986F	1984-85	1985-86
New Housing Permits (000)	218.0	240.0	220	10.1	–8.3
Single Units	107.3	110.0	107.8	2.5	–2.0
Multiple Units	110.7	130.0	112.2	17.4	–13.7
Total Valuation ($ Million)	26,487	29,625	30,419	11.8	2.7
Residential	14,514	17,371	17,330	19.7	–0.2
Single Units	8,372	9,956	9,557	18.9	–4.0
Multiple Units	4,574	5,217	4,995	14.1	–4.3
Alterations	1,567	2,198	2,779	40.3	26.4
Nonresidential	11,973	12,254	13,089	2.3	6.8
Commercial	5,643	6,221	6,629	10.2	6.6
Industrial	2,020	1,671	1,755	–17.3	5.0
Alterations	2,747	2,818	2,992	2.6	6.2
Other	1,561	1,544	1,713	–1.1	10.9

A = Actual F = Forecast

Industrial construction will take place mostly in the outlying areas as industrial space goes begging in the more densely populated parts of the state. For instance, in 1984 industrial vacancies surged in Southern California despite an improvement nationally. For the past three and half years, idle space in California's industrial sites has consistently topped the national average. Much of California's high vacancy rates in industrial sites can be attributed to a glut of industrial buildings that have recently been completed.

The continuing need to replace the nation's aging infrastructure promises continued public works growth. The movement of industry out of the larger metropolitan areas and into cheaper industrial parks in outlying areas will also continue to occur. Heavy and public works contracts are expected to replace nonresidential building as the lead market gainer in contract awards as commercial and industrial works fall back from their sizzling pace of 1984. Highways and bridge construction work will continue to lead transportation awards this year, with California perhaps becoming the biggest light-rail transit state in the union. Major port programs on the books, particularly in Southern California, should mean improved business. Military outlays will continue their steep ascent. In addition, a strong home building market is expected to stimulate demand for new sewage and waterworks systems. California's state and local governments are increasingly earmarking tax revenues and bond proceeds or turning to privatization to finance major construction projects.

Complicating matters is the President's proposed tax reform package which has led many an edgy developer to scramble to add to the already high volume of office space in California in order to qualify for the currently faster depreciation write off. In spite of the present surplus in office building space, developers are getting projects into the pipeline before changes in the tax code can be effected, thereby boosting construction plans forward. Nineteen eighty five may be the last year the lucrative depreciation allowance is available if Congress goes along with the administration's proposed tax code revisions. Tax reform in its present form would undercut private and public construction investment. Proposed reforms could hurt this process of capital formation and in the short run lead to widescale cancellation of infant projects.

In addition to federal tax reform legislation, federal budget cuts could also change the complexion of construction activity for the next several years. Budget cutting measures could stretch out some planned projects while eliminating others altogether. Currently, some commercial and apartment projects are heavily dependent on federal funds to leverage private investment. However, the combination of more competition and slower demand could force developers to lengthen their construction timetables. ■

THE OUTLOOK FOR CALIFORNIA'S REGIONS

The following articles discuss economic trends and the outlook for the state's three regions — Southern California, Northern Coastal California, and the Central and Mountain counties. The map on this page shows the geographical definitions of those areas.

☐ Northern Coastal California
▒ Central and Mountain Counties
☐ Southern California

SOUTHERN CALIFORNIA

The year 1984 saw the best overall growth for the Southern California economy since the late 1970s, and the first half of 1985 was characterized by some slowing in growth but at a pace above the nation's weak performance. Contributing to the region's better overall expansion during the first half of this year were continued gains registered in aerospace activity, residential construction, and services. Like the nation, weakness was evident in a number of sectors, including export activity, farming, and computers.

With the Southland in its third year of recovery, and the economy weakened by import competition, employment and income gains through 1986 will likely be well below the unusually strong increases recorded in 1984. However, low inflation and interest rates make continuation of the recovery likely, and the importance of the aerospace and service sectors in the region should enable Southern California to continue to outpace the growth rates registered nationally.

Over the past 2½ years, Southern California's economy more than recovered the ground lost during the 1981-82 recession. The region's growth pattern is indicated by the fact that the total nonfarm wage and salary employment increased about six percent last year, and year-over-growth during the first half of 1985 averaged about 4 percent. The seasonally-adjusted unemployment rate for the region's six metropolitan areas together was slightly below 7 percent as of mid 1985. Two years earlier, the corresponding figure was 9.5 percent.

Another trend during the first half of 1985 was that inflation rates remained relatively low in the third year of economic expansion. The Los Angeles area's Consumer Price Index increased about 4.5 percent during the first half of this year. The major forces holding down inflation rates — generally adequate supplies of labor and materials, a relatively highly-valued dollar, weak oil prices, and deregulation in a number of industries — are expected to limit price rises through 1986 as well.

Notwithstanding these generally favorable developments, the region's economy also faces a number of problems. For example, low farm and food prices have limited the growth of farm incomes, while weak oil and other energy prices have hurt many companies. Another continuing area of weakness consists of companies faced with heavy competition from imports. While the value of the dollars vis a vis other currencies dropped significantly during the first half of 1985, it still remains relatively high. This situation has limited the manufacturing activity in a number of sectors.

Southern California's overall economic growth pattern through 1986 is indicated by an expected increase in total nonfarm employment of between 3 and 4 percent. That rate of growth — about 1½ times the rate forecast for the nation — would of course be less than two-thirds the six percent growth rate experienced in 1984.

The unemployment rate for the region's metropolitan areas will likely begin to edge up by 1986 as jobs are not expected to be created quite fast enough to match new entrants into the labor force. Another factor contributing to the expected upturn in jobless rates is the faster growth in the number of job seekers that has been underway since early 1984 — reflecting in part the return of discouraged workers who left the labor market during the recession. After slowing to annual growth rates of less than 0.5 percent during the recession, growth in the region's labor force has accelerated to the most recent rate of about 4 percent per year.

Consumers have played an important role in the Southland's current economic recovery. Lower inflation and interest rates and favorable labor market conditions should fuel continued retail sales growth. However, the substantially reduced influence of pent-up demand from the 1981-82 recession and some slowing in employment and personal income gains should result in more limited growth in retail markets over the next 18 months.

An important contributor to the economic recovery pattern underway since 1983 has been housing, with increases in homebuilding activity continuing through the first half of 1985. All indications are that the region's housing unit authorizations this year will reach the highest level since 1978, with all of the 1984-85 gain likely to result from increased authorizations for multifamily dwellings.

A healthy estimated increase in Southern California's housing unit authorizations between the first half of 1984 and the corresponding period this year resulted from a number of factors — popularity of adjustable rate mortgages and lower mortgage rates, improved consumer confidence and housing affordability prospects, and a sharp rise in multifamily dwelling activity, which was due in part to tax incentives that favored investment in real estate. It is likely that 1985's strong level of multifamily dwelling activity was stimulated in part by efforts to realize the tax benefits of multifamily housing in advance of passage of a tax reform bill. This

SELECTED ECONOMIC INDICATORS: SOUTHERN CALIFORNIA

—	1977	1978	1979	1980	1981	1982	1983	1984
Growth in Total Wage and Salary Employment (%)*	5.7	7.4	5.1	1.5	1.6	–2.2	1.5	6.3
Real Growth in Taxable Retail Sales (%)**	12.9	8.0	2.7	–5.2	1.8	–2.9	7.7	10.0
Increase in Consumer Price Index (%)	6.9	7.3	10.8	15.7	9.8	6.0	1.7	4.6
Unemployment Rate (%)*	7.8	6.6	5.5	6.3	6.6	9.2	9.0	7.1
Annual Net Migration of Population (000)	148.6	158.7	148.7	144.5	126.1	137.9	115.0	102.0
Annual Housing Unit Authorizations (000)	153.4	134.9	111.9	77.0	59.2	41.7	94.1	134.0

*Based on data for Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara and Ventura counties.
**Adjusted for the "commodities less food" component of the Los Angeles - Orange County Consumer Price Index.

flurry of multifamily dwelling construction could well borrow from activity in future years.

Increased manufacturing activity and accelerated depreciation provisions enabled the area's industrial and commercial building activity to register strong gains during 1984 and in the first half of 1985. And, while many of the region's office markets have been plagued by high vacancy rates (a national pattern), the latest data show only a modest year-to-year decline in office permit activity. Over the next few years, the region's office construction activity is vulnerable to a slowdown as a result of high office vacancies, and the possibility of reduced tax incentives.

Southern California's aerospace-electronics sector comprises one third of its total manufacturing employment, and the region receives 20 percent of the DOD contract awards and more than 30 percent of the NASA contract awards. In the last few years, aerospace has definitely been a growth industry for Southern California. Sales to the U.S. government have shown strong gains so far during the 1980s, and the nation's commercial aircraft orders began to trend upward in early 1984 after several years of weakness. As a result, one of every eight jobs created in Southern California since early last year was in aerospace or electronics.

For all of this year, total U.S. aerospace sales will continue to rebound based on business that is already on the books. The military, space, and commercial aircraft segments all should show production increases this year. Futhermore, the federal government is obligated to increase defense expenditures through the 1980s simply to pay for the military hardware that has been ordered but not yet received. However, pressure to reduce federal budget deficits could well limit the growth of future defense budgets and government aerospace contractors' sales and profits.

Continued improvement is expected for civilian aircraft orders to replace the aging planes in the fleets of U.S. and foreign carriers. Demand for smaller transport aircraft is expected to be particularly strong. Airlines have been benefiting from growth in passenger traffic and from favorable fuel prices. However, slower worldwide economic growth will likely limit the future growth in air passenger traffic.

In the high tech segment, some computer manufacturers and their suppliers have been plagued by losses and layoffs. However, those declines in the region's high-tech industry have been offset by continued growth in the military electronics and aerospace-related segments.

The improved prospects for consumer spending and some categories of manufacturing during this recovery have stimulated growth for many of the region's service industries — particularly business, hotel, and personal services. The business services group is made up of a number of rapidly expanding activities, such as data processing services, building maintenance firms, private security services, and employment agencies. The

entire services sector currently accounts for about one fourth of the region's total employment.

As in 1984, the region's tourism industry is likely to experience mixed trends through 1986. The anticipated real increase in U.S. per capita personal incomes is a favorable trend, and Southern California as a travel destination stands to benefit from increases in statewide and local tourism promotion as well as from favorable publicity resulting from last year's Olympic Games. But a relatively strong dollar will likely limit foreign travel to the U.S. and encourage Americans to travel abroad.

To be sure, the dollar's value also has an important influence on international trade. While shifts in trading patterns lag changes in exchange rates by several months, a somewhat weaker dollar and better world economic conditions should increase demand some for U.S. exports through 1986.

Los Angeles is the major U.S. gateway to the Pacific Rim countries, and there are reasons for optimism about the region's foreign trade prospects over the longer term. In the years ahead, Asian countries are expected to register the highest long-term growth rates among the world's regions. The Southland's foreign trade activity also benefits from the fact that consumers in the Western U.S. have definite tastes for imported goods, and Southern California's personal incomes are about 15 percent above the national average.

CENTRAL & MOUNTAIN COUNTIES

In spite of the severe long-term problems facing California agriculture, many economic indicators for the Central and Mountain counties have shown a recovery pattern. However, the expected trends for employment, retail trade, and construction through 1986 will not match the gains recorded during 1984. Growth prospects are limited by the fact that many of the region's farmers face severe long-term problems, including reduced farm real estate values and surplus production of some commodities, which has depressed profits.

One of the most important sources of regional economic growth is the external demand for the products the region can produce at a comparative advantage to other areas. For most Central and Mountain counties, these include natural resource products ranging from raw agricultural commodities and processed foods to refined petroleum products and lumber. Also, high-tech manufacturing is an emerging industry in Some Central Valley communities.

Retail trade, services and government remain the leading employment categories in the Central and Mountain counties, and most employment sectors have shown job gains in 1984 and the first half of 1985. Total wage and salary employment in the region's eight major metropolitan counties (El Dorado, Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties) registered annual employment increases of 4.7 percent in 1984 and 6.1 percent during the first half of 1985. Jobs created in the retail trade, construction and manufacturing sectors have been major contributors to the Central & Mountain counties' increased employment. It should be noted that although the region's total manufacturing employment increased in 1984 and in the first half of 1985, the number of jobs in food processing has remained stagnant over the past several years.

High unemployment rates continue to be a problem for many counties in the region. Of the 33 Central and Mountain counties, only 5 counties (Alpine, El Dorado, Inyo, Placer, and Sacramento) had single digit unemployment rates in 1984. Layoffs by lumber and wood products producers and other manufacturers in the last quarter of 1984 helped keep many Mountain counties' unemployment rates at high levels.

Most Central and Mountain counties' unemployment rates should decline slightly through 1986 as a result of moderate growth in their respective labor forces coupled with continued, albeit slow, economic growth during the next two years.

The Central and Mountain counties' retailers experienced real sales gains in the first quarter of 1985 from the year earlier period. However, the gains made were only one-third the year-over-year increase recorded during the first quarter of 1984. New car dealers and lumber and building materials dealers outpaced all other retailers in total taxable retail sales, while farm implement dealers and farm and garden supply stores registered annual declines in their sales. With most consumers having already satisfied their pent-up demand during the early part of the recovery and the farm sector facing difficulties, real taxable retail sales growth should remain modest through 1986.

Homebuilding activity in the Central and Mountain counties was mixed during the first five months of 1985. In the 33-county area, the number of housing units authorized for construction during the January-

SELECTED ECONOMIC INDICATORS: 33 CENTRAL AND MOUNTAIN COUNTIES OF CALIFORNIA

	1977	1978	1979	1980	1981	1982	1983	1984
Growth in Total Wage and Salary Employment (%)*	4.1	5.9	4.8	2.0	1.6	–0.8	0.7	4.7
Real Growth in Taxable Retail Sales (%)**	11.2	9.2	3.2	–8.2	0.2	–2.2	10.6	5.6
Total Gross Farm Revenue (in $ Millions)***	5,945.7	6,281.7	8,651.3	9,685.8	9,406.1	8,926.7	8,160.0	8,429.4
Unemployment Rate (%)*	9.8	9.1	8.4	9.1	10.2	13.4	13.1	11.2
Annual Net Migration of Population (000)	84.8	82.6	81.6	76.1	66.1	62.3	55.5	49.5
Annual Housing Unit Authorizations (000)	63.6	62.6	58.3	35.3	25.4	23.9	41.0	45.1

*Based on data from El Dorado, Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties.
**Adjusted for "commodities less food" component of California's Consumer Price Index.
***Includes the region's 26 major farm counties.

to-May period totaled 19,740 — a 3.5 percent decrease from the year earlier period. The San Joaquin Valley (eight county area) recorded a drop in housing unit authorizations during the five months of 1985 compared with the same 1984 period — 13.1 percent. In contrast, the Sacramento Valley (10 county area) and the Mountain region (15 county area) registered year-over-year gains in total housing unit authorizations of 6.4 percent and 5.5 percent, respectively. Residential construction in the Central and Mountain region should show some slowing through 1986 as interest rates move upward.

Nonresidential construction in the region was also mixed during the first five months of 1985. Commercial building activity slowed down on a year-over-year basis, while industrial building increased significantly in both the Central and Mountain counties. The largest commercial sector is office building which continues to be plagued by high vacancy rates. For example, during the first half of 1985, Sacramento had the second highest downtown office vacancy rate and the highest suburban office vacancy rate in the state. Not surprisingly, office building in Sacramento County has slowed down. To illustrate, during the 1985 January-May period the total valuation of office building permits authorized in the county declined over 33 percent and 50 percent, respectively, from the corresponding 1983 and 1984 periods.

Oil production is an important economic activity for the region, with some of California's largest petroleum resources located in the San Joaquin Valley. The refining of crude oil into more usable products such as gasoline, jet fuel, residual fuel and asphalt is another important activity in the Central Valley. Ten of the 37 refineries in the state are located in the Central Valley, with seven of these located in Bakersfield. Also, the San Joaquin Valley accounts for about 60 percent of the state's natural gas production.

The San Joaquin Valley's petroleum production has remained flat in recent months due in part to lower prices and oversupplies. Petroleum production in the San Joaquin Valley rose only 2.0 percent in 1984 from the year earlier. Weak oil prices have also limited exploration and drilling programs of crude producers and have diminished demand for oil field services.

Another important industry to the region, particularly the Mountain counties, is lumber and wood products — an activity plagued by a dependence on the cyclical homebuilding industry. Lumber production plunged in the early 1980s, and picked up in 1982, with output increasing through 1984. However, the region's timber harvest in 1984 remained well below the levels reached in the late 1970s. Competition from Canadian lumber imports, a relatively strong dollar, and major structural changes within the industry all have contributed to the soft recovery, so far, experienced by the region's

lumber and wood products producers. Furthermore, employment within the industry continues to show no growth. In fact, employment within the lumber and wood products sector declined slightly — 2.0 percent — during the first 5 months of 1985 compared with the same 1984 period.

In 1984, many of the region's agricultural counties registered increases in cash farm receipts, followed declines in receipts in 1983. However, farm incomes have been weak. And because the ag sector is plagued by low product prices, high production costs and reduced land values, the near-term outlook for farm profits is not encouraging.

Employment within the agricultural industry increased slightly between 1983 and 1984; however, 1984's agricultural employment in the Central and Mountain counties was well below the 1980 peak level. The region's agricultural employment in 1985 and 1986 is not expected to change greatly from 1984's employment levels. (For a further discussion on the state's farming activity see the California Agricultural section).

NORTHERN COASTAL CALIFORNIA

The performance of the Northern California economy during the first half of the year paralleled the national pattern in several respects. As was expected, inflation in the region remained subdued and showed no signs of igniting. Also, retail markets continued to grow but at a modest pace, particularly when compared with 1983 and 1984. Reflecting another national trend, weakness in the local economy's industrial sector was counterbalanced by growth in services. Surprisingly, the weakness in high-tech that developed in the closing months of 1984 became more acute in the first half of 1985. A downtrend in mortgage rates that emerged in late winter was anticipated to spark additional activity in homebuilding and the real estate market. As with many other industries, the tourist trade was hampered by a relatively strong dollar, which was encouraging Americans to travel abroad and discouraging foreigners from visiting the U.S. Nonetheless, the tourist/travel business appeared to be having a good summer season, reflecting strength in domestic travel.

At midsummer, the prospects for the second half of the year and into 1986 were neither especially bullish nor gloomy. The local economy is not anticipated to slip into recession but should continue to grow at a moderate pace. Most of the expansion will be in homebuilding, retail distribution, and services, as was the case in the first half of the year. The turnaround in high-tech is difficult to call but it would be surprising to see a noticeable improvement before next year. During the summer months, high-tech production and work schedules were being pared to control inventories. Telecommunications equipment, aerospace, and military electronics are segments of high-tech that have largely escaped the downturn witnessed by the computer equipment and semiconductor industries — a condi-

SELECTED ECONOMIC INDICATORS: NORTHERN COASTAL CALIFORNIA

	1977	1978	1979	1980	1981	1982	1983	1984
Growth in Total Wage and Salary Employment (%)	4.6	6.0	4.7	3.4	1.4	–0.2	2.5	5.5
Real Growth in Taxable Retail Sales (%)*	14.2	2.9	3.9	–2.5	–2.7	–2.7	10.0	8.2
Annual Increase in Consumer Prices (%)	7.6	9.2	8.8	15.1	12.9	7.5	0.8	5.7
Unemployment Rate (%)**	7.4	6.2	5.5	5.6	6.3	8.2	7.8	6.0
Annual Net Migration of Population (000)	41.5	31.3	33.5	44.0	36.5	42.8	42.3	31.7
Annual Housing Unit Authorizations (000)	53.7	46.3	39.9	32.5	20.2	18.8	33.3	38.1

*Adjusted for Inflation with the "Commodities Component" of the San Francisco - Oakland Consumer Price Index.
**Nine-County San Francisco Bay Area.

tion unlikely to alter in the immediate period ahead. The high volume of homebuilding should stabilize production in the region's lumber industry in the coastal counties of Humboldt and Mendocino, though imports will continue to provide keen competition to domestic producers.

Inflation

Inflation in the region was moderate in the first half and should remain so in the balance of the year and in 1986. A flare up in prices is an unlikely prospect. Labor costs are rising at a modest rate of 3 to 3.5 percent, while oil prices, a principal contributor to inflation in the 1970s and early eighties, are likely to fall rather than rise.

During the first half of 1985, prices of consumer goods and services in the region advanced at an annual rate of five percent. Prices of commodities rose by half that amount, while prices of services moved ahead at a 6.3 percent clip. The prices of services, being less subject to competition from imports, recently have risen three times as fast as the prices of commodities. This gap should narrow some as a result of the downtrend in the international value of the dollar. For all of 1985, inflation in the region should hover around 5 percent. The prospects for maintaining inflation at the 5 percent level in the coming year are excellent.

Homebuilding

At midsummer, Northern Coastal California's homebuilding industry and real estate market were enjoying a good year, and the downtrend in mortgage rates that began in late 1984 promised a strong second half. Homebuilding activity during the first five months of 1985 was running at slightly above the high levels of a year ago. As a result of lower mortgage rates, the entire year may surpass the strong 1984 performance and turn out to be the best year for the industry since 1979.

During the first five months of this year, the region's total housing unit authorizations were up about 5 percent from the corresponding period of 1984. Construction of single-family residences was 3 percent shy of the year-earlier level, while multifamily residences were up by about 15 percent.

The condominium market is one segment of the housing industry that has moved counter to the improving trends. Weak sales and soft prices seem to be the norm in the industry. Overbuilding is cited as the culprit behind the condominium market's difficulties. But there may be another factor at work. The fall in mortgage rates to the lowest levels in six years has made single-family, detached housing financially accessible to more people. Lower mortgage rates have allowed not only more first-time homebuyers to enter the single-family market but also have encouraged the move-up market — condominium owners trading in their condos for single family homes.

Home prices moved slightly higher in the early months of 1985, as demand conditions strengthened. After showing no increase in 1984, home prices in the Bay Area appreciated at around a 3 percent rate in the first four months of this year.

Nonresidential Construction

Mixed trends and a crosscurrent of developments characterized construction of nonresidential projects in the early months of 1985. New office construction remained at a high volume throughout the first half of the year, as ground was broken on numerous projects — most notably in San Francisco, Santa Clara, and Contra Costa counties. The abundance of available space in the office market and in the production pipeline did not appear to deter plans for new projects.

The dollar volume of permits issued for commercial buildings in the region (largely office and professional buildings, retail stores, and hotels and motels) was up 15 percent during the first five months of 1985, compared with the corresponding period in 1984. While the permit data suggest that commercial development should remain strong in the immediate period ahead, commercial office space development is vulnerable to a slowdown, owing to abundant supplies of office space and high vacancies, which are at double digit rates throughout most of the region.

After two exceptional years of growth, construction of industrial properties in the 16-county region has slowed. The slower pace of industrial construction followed a year of unusually strong activity and is a response to uncomfortably high vacancy rates and the diminished industrial space requirements of the high-tech sector. During the first five months of 1985, industrial permit valuations were down 42 percent from the corresponding 1984 level. The slower pace of industrial development is likely to persist for at least the balance of this year and is not likely to show material improvement until the region's most important industry — high-tech — is well into its next expansion.

Labor Market

Mixed trends characterized labor market conditions in the region during the first half of 1985. Overall, the local economy continued to generate jobs during the first six months of the year. Unemployment rates for the entire region remained low, rising to a high point of 6.3 percent in June, as the lay-offs in high tech finally began to be reflected in the jobless figures. The non-seasonally adjusted jobless rates in Humboldt and Mendocino counties, the areas in which unemployment rates are often the highest, stood at 8.5 percent and 8.7 percent, respectively, in May. The comparable rate for Monterey County was 7.7 percent and 7.3 percent for Santa Cruz County.

The aggregate employment figures mask some of the weaknesses that developed on the local labor market as the first half of 1985 unfolded. Nearly all — over 80 percent — of the new jobs created in the first half were in three sectors — construction, retail trade, and services. The other industry groups — manufacturing; transportation and public utilities; finance, insurance, and real estate; and government — showed either a reduction in their labor pool or a small increase. In 1983 and throughout most of 1984, job creation was more widely dispersed among industry sectors.

The second half of the year is not likely to see a significant change from the first half pattern. Most of job growth will continue to be in services, retail distribution, and, to a lesser extent, construction. Employment in manufacturing should remain steady; most of the payroll cutbacks in high-tech likely have been made. Employment growth for the entire year is forecast at around 3 percent, which represents half the rate recorded for 1984. Unemployment rates are likely to move modestly higher in the second half of the year. ■

THE SHORT-TERM U.S. OUTLOOK

THE OUTLOOK FOR REAL GROWTH

During the past year, the U.S. economy has gone from a period of exceptionally rapid growth to one of sluggish expansion. During the first half of 1985, real GNP grew at a rate of only about 1 percent. This weak expansion, combined with the structural problems of the budget deficit and the trade imbalance, has led to increased fears that a recession may be just around the corner.

Although the economy's recent performance leaves much to be desired, there are few signs of impending recession. Consumer spending intentions remain strong. Short-term interest rates recently attained their lowest level since the late 1970s and long-term rates are not far behind. The dollar has plunged more than 15 percent against other major currencies since early this year. The economy's inventory situation appears very lean. Inflation remains moderate even with very rapid money growth. Low oil prices and the strong growth of the money supply during the first half of the year are expected to provide a stimulus to the economy. All of these factors argue for a stronger expansion through the end of 1986.

However, there are significant structural weaknesses in the U.S. economy, and they will limit the scope of the expansion. Consumer indebtedness is now very high relative to disposable income, which rules out a major debt-fueled expansion in consumer spending. Commercial structures are in oversupply in most areas of the nation, and this excess will ultimately produce a sharp downturn in new commercial building. Although we anticipate progress on the federal budget deficit, the 1986 shortfall will still be very large — about $180 billion. The decline of the dollar will benefit U.S. exporters in 1986 and beyond, but the trade balance is likely to worsen in the near term.

In summary, the economy will continue to grow at a real rate of 3 to 4 percent. Somewhat higher growth rates will be realized in late 1985 and early 1986 as inventories are restocked. Areas of primary strength will be spending for durable goods and for services, business spending for durable equipment, residential investment, and (for the next several quarters) inventory investment.

FORECAST HIGHLIGHTS
1984-1986
(Billions)

	1984A	1985F	1986F
Gross National Product	3662.8	3905.6	4214.4
% Change	10.8	6.6	7.9
Real GNP (1972 $)	1639.3	1679.3	1740.0
% Change	6.8	2.4	3.6
GNP Deflator (1972 = 100)	223.4	232.6	242.2
% Change	3.8	4.1	4.1

A = Actual F = Forecast

FINANCIAL DEVELOPMENTS

In 1986 the Federal Reserve Board intends to continue its battle with inflation. Unfortunately, events in 1985 make this difficult. In their efforts to keep the aging recovery from flickering out the Fed spent a good deal of 1985 in a stimulative mode. The narrow measure of the money supply, M-1, violated the Fed's target bands repeatedly throughout 1985.

By 1986 the Fed could be on the horns of a dilemma. They could be faced with the choice between trying to prolong a recovery through greater money supply growth or dampen a resurgence in inflation by putting the brakes on money supply growth. Congressional pressure will be strong, as it has been over the last year, for the Fed to provide sufficient stimulus. However, the Fed views its job as an inflation fighter first and foremost, and has used its autonomy to resist such pressures when necessary. In 1986, if inflationary expectations come back, it is highly likely that we will see the Fed spend much more time in a restrictive mode than they have in recent years.

One scenario is possible for 1986 that could change this conclusion: the loss of several key players from the Federal Reserve Board, including the Chairman himself, Paul Volcker. Fed Governor Lyle Gramley has resigned and Governor Charles Partee's term of office will expire in 1986. What is more important, however, is that President Reagan will get the opportunity to name their replacements. Reagan has already had the chance to name two members to the board, Governors Seger and Martin. Both of these individuals has shown the propensity to lean towards more stimulative monetary policy under any environment; it is likely that future Reagan nominees will share similar philosophies. Fed Chairman Volcker, the architect of tight money supply designed to reduce inflation, may feel that it is time to leave the Board if there are so many monetary "doves" to contend with. The departure of Volcker would undoubtedly be taken very poorly by the financial markets.

Financial markets face the possibility of greater regulation in 1986. Discussions are underway for the regulation of the government securities dealer market in the face of several firms that have collapsed. The Fed, which already has some regulatory authority over the 36 primary dealers, has expressed a willingness to expand its regulatory authority to the remaining secondary dealer market.

CONSUMER SPENDING

Although real output expanded only 1.9 percent during the second half of 1984 and the first half of 1985, real consumer spending grew at almost twice that rate — 3.7 percent. The problem for the economy was that much of that consumption is subtracted out of GNP when allowance is made for imports. Consumption of domestically manufactured goods probably declined during that period, with only the consumption of services making a net positive contribution to GNP. Consumer spending has been, thus, both a strength and a weakness to the economy during the last year or so of the expansion.

Imported goods will likely continue to dominate the markets for certain types of goods through the remainder of 1985 and in 1986. Durable consumer goods such as videocassette recorders (VCRs) have virtually no domestic content, and even such an "American" product as the personal computer consists mainly of imported parts. The strong popularity of such products during the past several years has made import dominance particularly painful. Even such traditionally domestic categories of durable consumer goods as furniture and home appliances now face very strong competition from imports. The causes of this import surge probably have more to do with exchange rates (the strong dollar) than with consumer preferences or cheap foreign labor; domestic manufacturers, therefore, should begin to benefit from the recent decline of the dollar as soon as next year.

The automotive market, in many respects, has been a microcosm of the forces that are likely to determine the future extent of imported goods in our economy. Twenty years ago, imports accounted for less than 10 percent of U.S. auto sales. By 1982, the import share had risen to about 28 percent, and appeared to be headed higher. More ominously, about half of first-time buyers were choosing imports. Only one foreign maker was producing cars in the U.S. Partly in recognition of these trends, and as a result of a depression in the domestic auto industry in the early 1980s, a voluntary "quota" system was negotiated with Japanese producers. This agreement, which took effect in 1982, limited Japanese imports to the U.S. to about 1.7 million autos per year.

The voluntary restraint agreement was allowed to lapse early this year, partly because the domestic industry had made a strong recovery, and partly because the anti-competitive effects of the agreement appeared to be too costly to consumers. Importers, however, had learned an important lesson. By mid 1985, at least 5 foreign producers were making cars in the U.S. and several others were looking for plant sites. With these producers are likely to come ancillary activities such as parts production. Although these autos will in most cases have significantly less domestic content than "American" cars, their impact on the economy will be less damaging than that of pure imports.

During the second half of 1985 and through 1986, we expect auto sales to maintain an annual rate of 10.5 to 11 million units, of which more than 70 percent will be of domestic manufacture. This sales rate is supported by a favorable interest rate outlook (probably with some continuation of dealer incentive programs such as below-market financing), rising employment levels, and higher real incomes. There may also be some pent-up demand remaining, since the average age of the auto stock is still very high.

ECONOMIC OUTLOOK

Selected Economic Indicators

	1985				1986				ANNUAL		
	I	II	IIIF	IVF	IF	IIF	IIIF	IVF	1984	1985F	1986F
Housing Starts*	1.80	1.77	1.75	1.80	1.85	1.85	1.80	1.75	1.77	1.78	1.81
Automobile Sales*	10.8	11.0	10.2	11.2	11.2	11.0	10.9	10.9	10.4	10.8	11.0
Personal Income	3143.8	3181.6	3230.0	3283.3	3343.1	3401.5	3458.0	3512.1	3012.2	3209.7	3428.7
% Change	6.3	4.9	6.2	6.8	7.5	7.2	6.8	6.4	9.8	6.6	6.8
Disposable Personal Income	2654.8	2734.5	2762.0	2802.0	2850.5	2897.9	2943.1	2986.7	2576.8	2738.3	2919.6
% Change	1.6	12.6	4.1	5.9	7.1	6.8	6.4	6.1	10.1	6.3	6.6
Saving Rate (%)	4.5	5.6	5.0	4.9	4.9	5.0	5.1	5.2	6.1	5.0	5.1
Industrial Production Index (1977=100)	123.8	124.4	125.6	127.1	128.7	129.9	131.0	132.0	121.8	125.2	130.4
% Change	2.3	2.0	3.9	4.9	5.1	3.8	3.4	3.1	11.6	2.8	4.1
Unemployment Rate (%)	7.3	7.3	7.3	7.2	7.2	7.1	7.1	7.1	7.5	7.3	7.1
Producers Price Index (1967=100) Finished Goods	292.3	294.0	295.9	298.1	300.3	302.7	305.3	308.3	291.2	295.1	304.2
% Change	0.8	2.3	2.6	3.0	3.0	3.2	3.5	4.0	2.1	1.3	3.1
Consumer Price Index (1967-100)	317.8	321.1	324.0	327.1	330.2	333.4	336.7	340.7	311.1	322.5	335.3
% Change	3.2	4.2	3.7	3.9	3.8	3.9	4.0	4.8	4.3	3.7	4.0

*Millions F = Forecast

Although the outlook for consumer purchases of durable goods is generally quite favorable, there is one cloud on the horizon. The consumer debt load, as measured by the ratio of installment debt to disposable income, has recently reached record levels. This ratio reached 18.5 percent in June 1985 compared with the prior cyclical peak of 17.8 percent in 1979. These ratios should be interpreted with caution, since the average maturity of installment loan contracts has lengthened in recent years (car loans reached a new all-time high of 47.2 months in the second quarter of 1985), so that a given amount of debt has a lower annual payment stream. The ratios do indicate, however, that consumer borrowing is likely to expand more slowly through 1986.

Consumer spending for nondurable goods grew at a low real rate of only 2 percent from mid 1984 through the second quarter of 1985. About half of this category consists of food, which grew 3.4 percent. Those gains were offset by declining purchases of fuel (both automotive purchases of gasoline and oil and home heating oil were off) and weak growth of clothing and shoes (another area of substantial import penetration). The services sector of the economy fared somewhat better, as real spending expanded 3.9 percent.

The services were led by a large catch-all category which includes entertainment, medical, financial, personal, and business services, which collectively grew 4.6 percent. Also providing strength were housing services, which grew 4 percent in real terms, and transportation services, which gained 3.7 percent. Weak areas of service spending included the utilities component of household operation, which declined.

OUTLOOK FOR INVESTMENT

While many analysts significantly underestimated the strength of the 1983-84 economic recovery, the behavior of fixed investment spending left even the most optimistic forecasters far from the mark. After declining 1.9 percent from 1979 through 1982, fixed investment rose 9.7 percent in 1983, and a stunning 18.0 percent in 1984. This performance is particularly surprising since it took place during a period of historically high nominal and real interest rates.

Although fixed investment comprises just over 12 percent of Gross National Product, strong advances in plant and equipment spending during 1983-84 helped turn an average economic recovery into a robust expansion. To illustrate, we compare the performance of real GNP against real GNP without fixed investment over the last two years. Real GNP rose 3.7 percent in 1983, and 6.8 percent in 1984, which is an above average gain in total output for the first two years of an economic recovery. Real GNP excluding investment rose just 2.4 percent in 1983, and 4.6 percent in 1984, which is a far below average increase for this measure of output during the first two years of an expansion. Although business investment is usually more sensitive to the business cycle than most other GNP components, it is clear that investment was the "star" performer of the 1983-84 recovery.

One of the most interesting questions facing economic forecasters today is whether the recent boom in investment can be maintained. Some observers have suggested that the present behavior of investment is not terribly surprising, since the long-term record for capital spending since the 1960s, has not been particularly strong. Between the late 1960s and 1970s, the share of real ouput devoted to nonresidential fixed investment declined by more than 30 percent, while the growth rate of the nonresidential capital stock decreased nearly 40 percent. Therefore, the recent advances in investment reflect the capital stock "catching up" to its typical, historical growth path. It has also been argued that the Economic Recovery Tax Act (ERTA) of 1981, which significantly reduced business taxes, and declining real energy costs, have stimulated investment since both of these factors have lowered the cost of capital.

Similarly, it is argued that some of the proposed tax changes in the Treasury II plan may increase the firm sector's tax burden, and reduce incentives for investment. The specific changes which may inhibit investment include the elimination of the investment tax credit, limitations on accelerated depreciation in the early years of investment, and the recapture of windfall gains from prior accelerated depreciation. Although some changes in Treasury II (reductions in corporate income taxes, and a 10 percent deduction in dividends paid) would likely benefit investment, the net effect would seem to be negative. Since tax issues are always an important factor in examining investment behavior, any forecast of business fixed investment is conditional upon an assumed tax treatment of expenditures.

Although it is clear that the removal of the investment tax credit and limitations on accelerated depreciation would have negative near-term implications for investment, it is not clear whether these changes will be part of a final package, nor is it clear when a final tax reform plan will be considered. In light of the uncertainty surrounding tax reform, we have assumed that there will be no major changes in the tax treatment of investment through 1986.

OUTLOOK FOR REAL GROWTH

(Percent Change)

	1985				1986				YEARS		
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	1984A	1985F	1986F
Gross National Product	0.3	1.8	2.9	4.3	4.2	3.8	3.2	3.1	6.8	2.4	3.6
Personal Consumption Expenditures	5.2	5.2	2.7	5.5	4.0	3.3	3.3	2.9	5.3	4.2	3.9
Durables	9.3	7.9	–2.9	13.5	3.3	1.6	2.7	2.8	13.1	7.0	4.2
Motor Vehicles & Parts	9.8	9.0	–11.1	29.8	2.0	–1.9	1.5	2.9	13.7	4.4	4.5
Other Durables	8.9	7.1	3.3	3.3	4.3	4.3	3.5	2.8	12.6	8.9	3.9
Nondurables	3.7	5.9	3.9	4.0	4.1	3.4	3.2	2.9	4.6	3.1	3.8
Services	4.9	3.7	3.9	3.9	4.1	3.9	3.5	3.0	3.3	4.0	3.8
Gross Private Domestic Investment	3.1	–5.9	9.6	9.4	7.4	4.8	3.3	2.8	31.2	1.4	5.8
Fixed Investment	–0.1	13.7	3.7	4.1	5.0	3.9	2.8	2.7	18.0	6.3	4.5
Nonresidential	–1.5	13.6	3.5	4.0	4.5	4.1	2.8	2.8	19.8	7.2	4.4
Producers' Durable Equipment	–5.6	11.5	4.9	5.4	5.6	5.5	4.2	3.9	21.5	6.0	5.5
Structures	9.8	19.0	0.0	0.6	1.9	0.6	–0.6	0.0	15.6	10.5	1.7
Residential	5.5	14.0	4.6	4.5	6.5	3.1	2.5	2.5	12.2	3.1	4.9
Change in Inventories ($)	19.1	5.8	9.9	13.7	15.6	16.4	16.9	17.1	24.8	12.1	16.5
Government Purchases	0.3	3.9	1.8	1.5	1.5	1.8	1.5	1.6	3.5	3.9	1.8
Federal	0.6	2.5	2.5	2.5	0.6	1.2	0.9	0.9	5.4	6.9	1.5
National Defense	0.0	9.4	3.0	2.5	0.8	1.3	1.2	0.8	5.8	5.7	2.1
Nondefense	3.3	–13.3	1.1	2.2	0.0	1.1	0.0	1.1	4.5	10.1	–0.1
State & Local	0.0	5.0	1.3	0.9	2.2	2.2	1.9	2.2	2.2	1.9	2.0
Net Exports ($)	–28.4	–33.7	–37.4	–42.5	–42.7	–41.1	–40.1	–38.5	–15.0	–35.5	–40.6
Exports	–8.9	–12.5	–3.4	–4.0	3.0	9.0	11.0	10.4	4.7	–4.7	2.3
Imports	32.2	1.4	5.9	8.7	2.7	3.1	6.1	4.4	27.0	8.5	4.7
Final Sales	–0.3	5.1	1.9	3.4	3.7	3.6	3.2	3.1	5.0	3.3	3.4

A = Actual F = Forecast

PROFIT PERFORMANCE BY INDUSTRY
(Billions of Dollars)

	1981:3	1982:4	1984:2	1985:1
Pre-tax Profits, Total	202.7	143.2	238.7	223.2
Domestic Corporations	180.3	119.7	217.5	202.5
Financial	17.4	24.9	28.9	28.0
Nonfinancial	162.9	94.8	188.6	174.6
Manufacturing	90.9	42.4	92.3	77.9
Durable Goods	20.2	−6.3	27.6	27.2
Nondurable Goods	70.8	48.7	64.7	50.8
Trade	32.7	24.1	47.0	45.5
Regulated Industries*	20.3	13.3	28.3	29.0
Other Industries	19.0	15.1	21.0	22.1
Rest of World	22.5	23.5	21.3	20.7

*Transport and Public Utilities

Security Pacific Bank continues to project healthy, though somewhat smaller, gains for investment in 1985-86. This forecast reflects an accelerating economy, additional declines in the price of crude oil, and only modest increases in real interest rates. In the nonresidential investment category, expenditures on producers' durable equipment are predicted to increase significantly, rising 7.2 percent in 1985, and 4.4 percent in 1986. Investment in nonresidential structures is expected to increase 10.5 percent in 1985, reflecting a very strong first half of the year. Spending in this category will stagnate over the balance of 1985 and through next year, reflecting high vacancy rates in office buildings in many urban areas. Residential construction will increase 3.1 percent this year, and 4.9 percent in 1986, as the recent major decline in nominal interest rates, increased economic activity, and positive demographic factors result in gains for new housing starts.

CORPORATE PROFITS

The last year was not a highly profitable one for U.S. businesses. With a low inflation rate, many firms have seen margins shrink to low levels. Additionally, the weak trend in output since mid 1984 has meant that volume was making only slight additions to earnings. The result has been profit levels for the economy as a whole that are lower, in mid 1985, than year-ago levels. The experience of different sectors of the economy has varied considerably. The following table shows pre-tax data for major industry groupings for four dates. The first column shows the business cycle peak in the summer of 1981, followed by the trough at the end of 1982. The third column shows the recent peak for profits, in last year's second quarter, followed by the most recent data presently available, the first quarter of 1985.

Although profits have increased substantially from the trough of late 1982, they remain only about 10 percent above their level at the 1981 cyclical peak. The more ominous trend is the decline from last year's peak reading, which was an all-time record for pre-tax profits. The weakness since mid 1984 has not been evenly distributed. The manufacturing sector of the economy has shown the largest decline, accounting for over 90 percent of the decline in pre-tax earnings. Of that share, most was accounted for by nondurable goods manufacturing. Major subsectors of nondurable goods include food, chemicals, and petroleum products, which have all seen declining profits during the last year. Relatively modest declines in pre-tax profits have been shown by financial corporations, wholesale and retail trade, and the rest of world sector.

Profits in the remainder of 1985 and in 1986 should experience a revival from the moribund trend of the recent period. The economy has recently been building inventories at a very slow pace, and consumer spending intentions, while not at a record level, are still very strong. These trends indicate strong gains in production and real output during the second half. Margins are presently benefiting from the drop in interest rates, and the rise in labor costs is expected to be moderate. On an after-tax basis, profits are projected to decline about 2 percent this year (due entirely to the weak first half), followed by a strong gain of 13 percent in 1986.

At this time it does not appear likely that tax reform proposals will have major impact on the level of profits, although the interaction of changes in tax rates, depreciation schedules, tax credits, and other factors would affect industries differently.

In 1986, the decline of the dollar will become more of a factor in the earnings picture. The currency has already declined more than 15 percent on a trade-weighted basis from its February peak, and is projected to fall somewhat further from its present level. The weaker dollar will directly benefit earnings from the rest of world sector, since a given profit level in foreign currency will translate into more dollars. Secondly, domestic producers of a wide variety of goods will benefit from a more competitive position in world markets.

GOVERNMENT SPENDING

In the nick of time, the Congress recently approved a budget compromise which resolved an impasse that had threatened to block passage of any deficit reduction in the current legislative session. The compromise measure slows the growth in both defense and non-defense spending for fiscal year 1986, and reduces next year's deficit by an estimated $56 billion (based on very dated and bullish economic assumptions).

Our estimate of the unified budget deficit for the 1985 fiscal year is about $200 billion, which is up from last year's $175 billion shortfall, reflecting the slower growth that began at mid-1984. This year's deficit has been helped somewhat, however, by the concurrent decline in short-term interest rates — now about 4 percentage points below last year's peaks.

Even with the recently approved spending cuts, the budget deficit for fiscal 1986 will likely approach $180 billion. The salutary effect of next year's higher economic growth rate will be offset to some extent by a higher path for interest rates, and by the fact that next year's revenues will also be influenced by the economy's performance in 1985. Three-month T-bill rates are expected to average nearly 8.5 percent next year, up about a percentage point from this year's level.

INTERNATIONAL DEVELOPMENTS

By any measure, the international position of the U.S. will remain in a very large deficit position through 1986. The trade and current account figures for the second quarter showed record deficits, as did the GNP category of net exports. Although the dollar's value has declined sharply against other major currencies — more than 15 percent on a trade weighted basis from its February peak — the effects of the weaker dollar on the domestic economy will be lagged. Initially, import prices will show little effect and consumer demand for imported goods will remain at a high level, and the merchandise deficit will probably continue upward until late this year.

The key question for the U.S. international position in 1986 is where the dollar goes from here. Will it continue to decline rapidly, decline more slowly, or strengthen once again? Although it is easy to identify risks that could push the dollar in either direction, we lean toward the outlook for a slow decline. The decline will be slowed in our view by the firming of interest rates, the moderation of U.S. economic growth, some resolution of the fiscal impasse, and the expectation that the nation's trade and current account positions will improve slightly later in 1985 and even more in 1986.

By early 1986, the weaker dollar will begin to bite into demand for imported goods, which will be higher-priced in dollar terms. Exporters will begin to benefit from the stronger margins which the weaker dollar will provide them in international competition. Although the current account deficit will likely balloon to $130 billion in 1985, it should moderate to the $120 billion range in 1986. While these trends in the dollar and the current account position will not restore the U.S. competitive position to anything like its status quo ante, they will reverse the steady deterioration since 1981.

INFLATION OUTLOOK

One of the most important economic developments of the 1980s has been the significant decline in the nation's rate of inflation. Measured by any price index, the inflation rate has decreased substantially, dropping from the double-digit range of the 70s to its recent average level of approximately 4 percent. The recent change in the U.S. inflation rate is notable not only because of its magnitude, but because it has been sustained for three years.

A distinguishing characteristic of business cycles is inflation's tendency to increase, often with a lag, during expansionary phases of the cycle and to decline during recessions. Therefore, lower inflation rates associated with the 1982-83 recession were very much in line with historical experience. Similarly, it was expected that the 1983-85 expansion, coupled with a very stimulative fiscal policy, would result in a significant increase in inflation. However, the fact that inflation has remained modest entering the third year of the expansion suggests that the recent change in inflation is not simply a transitory, business cycle result, but reflects fundamental changes in the economic processes governing inflation.

One factor which has recently had a significant effect on inflation has been the unexpectedly strong appreciation of the U.S. dollar in foreign exchange markets. The rapid appreciation of the foreign exchange value of the dollar, primarily reflecting the relative safety of U.S. investments and interest rate differentials, has had a moderating effect on inflation. Since 1980, the dollar has advanced markedly against a trade-weighted average of other major currencies, rising nearly 80 percent from its 1980 average to its peak in the first quarter of 1985. An "expensive" dollar promotes low inflation by keeping import prices low, which in turn keeps the prices of substitutable domestic goods low. It has been estimated that the increase in the value of the dollar over this period has reduced inflation by 1 to 1.5 percentage points this year.

Although inflation should remain relatively moderate through 1986, we do expect a slight increase in the overall rate over the forecast period. This forecast reflects the more accommodative monetary policy pursued by the Federal Reserve Board in late 1984 and early 1985, as well as the recent decline in the value of the dollar from its first quarter peak on foreign exchange markets. Inflation, as measured by changes in the Consumer Price Index, is expected to be 3.7 percent in 1985, and should rise to 4.0 percent in 1986.

Good news on energy costs should continue. Spot market prices for Saudi Arabian light crude oil recently fell $1.50 to $2.00 below official list prices, and Saudi Arabia's efforts to half price declines through reduced production have been neutralized by weak demand and production above quota by other OPEC members. As a result, prices for crude oil products are anticipated to remain weak through 1986.

As aggregate economic activity increases in late 1985, increased demand for industrial and construction goods, such as metals, metal products, and lumber, should lead to moderate price hikes. Weakness in the petroleum sector, however, will result in prices for chemical products, and rubber and plastics, rising slightly.

On balance, food price increases should remain modest over the forecast period. Farm product prices dropped at a 16.7 percent annual rate in the first half of 1985, with no real recovery in sight. Farm prices continue to be depressed by high production. Although a declining value of the dollar should lead to higher agricultural prices, its effects will be dwarfed by current surpluses.

EMPLOYMENT OUTLOOK

The nation's civilian unemployment rate has been stable at 7.3 percent since February, and we are not predicting much change in this rate for the balance of 1985. Moderate economic growth in 1986 will continue to provide a stable environment for the labor market. The unemployment rate should decline to an annual average of 7.1 percent in 1986. The employment outlook is optimistic for both 1985 and 1986. In the second quarter of 1985, nonfarm payroll employment reached an unprecedented 97.5 million, and is expected to grow to 101 million within the next 18 months.

Payroll employment has gained over 7 million jobs or 9.7 percent, since the trough of the last recession in 1982. Service-producing employment recorded a gain of 9.9 percent, with strong performances within the service, wholesale, and retail groups. For that same period, the manufacturing group grew by 7.2 percent, while the relatively weak mining sector lost 4.8 percent of its work force. Wage increases within the construction, mining and transportation sectors have been modest compared to the other industrial groups during this expansion period. High unemployment, deregulation, and pressures from foreign competition have weakened unions' collective bargaining power in these industries. However, these workers, representing just over 10 percent of the total nonfarm employment, are still the highest paid group of employees in the nation.■

ECONOMIC INFORMATION SERVICES FROM SECURITY PACIFIC

Security Pacific's Economics Group offers a number of research services to meet the needs of business, government agencies and individuals.

"California Construction Trends"—Each issue of this monthly subscription publication helps you keep abreast of residential, commercial, and industrial construction for all of California's cities and counties.

California Database—The largest and most accurate computerized collection of economic data available for California's cities, counties, metropolitan areas and the state itself. Information from the data base is available online, through magnetic tape, diskette or in hard copy form.

International Trade Databank—Provides for each of the 44 U.S. customs districts, the value and quantity of commodities exported from or imported to every country in the world. Reports are customized to your needs. Import/Export lists are also available.

Monthly Monitor—For the past several years, this comprehensive monthly newsletter has provided Security Pacific's management with valuable economic information. The timely quantitative forecasts and written analyses of the U.S. economy are now available to you to facilitate your business decisions.

To obtain additional information about these resources, please return the enclosed post card to: Security Pacific Bank, Economics Department, H8-2, P. O. Box 2097, Terminal Annex, Los Angeles, CA 90051, or call (213) 613-5976.